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TAX CONSEQUENCES OF

Corporate organization and distributions

EDITED BY RICHARD L. GREENE, LL.B.

How to use recapitalizations to effect tax planning objectives

by **RICHARD R. TESCHNER**

Recapitalizations which are imaginative and intelligent can provide solutions to seemingly insoluble corporate stockholder tax problems. Since the device can effect a transfer of value or control tax-free, it is especially useful when the interests of the older stockholders (who want to protect their interests after they retire) conflict with the interests of younger stockholders who want to take risks and move aggressively ahead. Each group can be satisfied by the proper type of recapitalization, and each group can get the best tax treatment. How to achieve these results are here detailed by the author, who originally presented this paper in a talk before the Seventh Annual Tax School of the State Bar of Wisconsin.

SECTION 368 OF THE 1954 Code tells us that a "reorganization" includes "a recapitalization," but nowhere does the Code define "a recapitalization." The Supreme Court has defined a recapitalization to be "a reshuffling of the capital structure within the framework of an existing corporation."[1] A recapitalization, unlike any other type of reorganization, involves only a single corporation; all other reorganizations involve at least two corporate entities. Strictly speaking, a stock dividend is not a recapitalization,[2] but it may yield the desired result and we will discuss the two together here.

The chief significance of any action being a "reorganization" or a part of a "reorganization" is, of course, that if it is, it is the first long step toward the action being "tax-free."

Bear in mind that to the extent a supposed "recapitalization" has the effect of an ordinary dividend, it will be treated as such and not as a reorganization.

Equivalent to a dividend

Assume, for example, a corporation with three shareholders. Many years ago, at the inception of the business, each shareholder purchased 100 of its presently outstanding 300 shares of stock. Each paid $10 per share, $1,000 for the lot. If each turns half his shares in for $2,000 of preferred stock, $2,000 of notes and $1,000 cash, then the transaction will be, literally, a recapitalization. It will not be treated as such, however, because the effect is exactly the same as if the corporation had issued to each a stock dividend of preferred stock, a property dividend of notes and a cash dividend. Each shareholder will be charged with $3,000 of ordinary dividend income (the cash and property)[3] and the preferred stock will be "Section 306 stock" just as if it actually had been distributed by way of a stock dividend.

On the other hand, suppose that one of these shareholders desires to retire, that he would like to redeem his shares for cash but that the corporation cannot stand the full cash drain. Consequently, in exchange for all of his common shares, he receives $5,000 of preferred stock, $1,000 of cash and $4,000 of notes. This transaction is also a recapitalization. However, it is not wholly tax free because the retiring shareholder is receiving for his stock not only stock but also money and other property (the notes). Of his gain of $9,000, the $5,000 represented by cash and notes is recognized for tax purposes. There is still the question, however, of whether it will be recognized as a capital gain or as a dividend. Section 356(a)(2) specifically states that if the exchange has the effect of the distribution of a dividend, then so much of the recognized gain as is not in excess of the shareholder's ratable share of the undistributed earnings and profits shall be treated as a dividend and only the remainder treated as a capital gain. While the Regulations under Section 356(a)(2) are not helpful, it seems reasonable to believe from the Regulations under the similar language of Section 306(c)(1)(B), dealing with a related problem, that if the retiring shareholder is not "related"[4] to the continuing shareholders, then there is no dividend. In any event, it is clear that if he is "related," then the Service may very well claim that the exchange has the effect of a dividend. Assuming the exchange does not have the effect of a dividend, the recognized gain is taxable as a capital gain, and the remainder of the gain, that is, the $4,000 of gain attributable to the $5,000 of preferred stock received, is not recognized for tax purposes. Instead the preferred stock will be held by him with a basis of $1,000.[5] This $4,000 of unrecognized gain will be recognized to him only when he sells the preferred stock or exchanges it in a taxable transaction. If he holds it until his death, it will receive a new basis at that time, and the gain will never be recognized for income tax purposes.[6]

The withdrawing shareholder may well incur a capital gain tax approaching the $1,250 maximum on the $5,000 of recognized gain. Since the tax is slightly more than the cash that he derives from the transaction,[7] he may prefer to take, in lieu of the serial notes, a preferred stock redeemable serially either by its terms or by a purchase contract between the retiring shareholder and the corporation.

For another simpler example of a recapitalization which has the effect of a dividend and is therefore treated as a

[1] Helvering v. Southwest Consol. Corp., 315 U.S. 194.
[2] Bazley v. Comm., 331 U.S. 737.
[3] Regs., §1.356-1(b) and (c) *Example (1)*.
[4] Regs., §318(a).
[5] Section 358.
[6] Section 1014.
[7] Query whether the recognized gain upon a partially tax free transaction such as this may be reported on the installment method? Section 453 (Installment Method) speaks of "a casual sale

dividend and not as a recapitalization, consider a corporation with 6% preferred stock outstanding and in arrears. The corporation offers to exchange for the outstanding 6% preferred stock new 5% preferred stock equal to the par value of the old stock plus the amount of the dividends in arrears. Under Section 305(b)(1), a distribution of stock or stock rights, even though normally nontaxable, is considered taxable to the extent that it is made in discharge of preference dividends for the current or immediately preceding taxable year. The Regulations say[8] that such an exchange is ordinarily a recapitalization. But if it is made solely to effect the payment of dividends for the current and immediately preceding taxable year, then the value of the stock issued in lieu of such dividends will be treated as a dividend under Section 305(b)(1).

The business-purpose rule

The chief significance in the difference between a stock dividend (not a taxable dividend) and a recapitalization is that there is no business purpose required for a stock dividend, whereas a business purpose is required for a recapitalization. Under the 1939 Code, when you could recapitalize by exchanging outstanding preferred stock for debentures, this business-purpose problem was very important. While such an exchange would still be a recapitalization under the 1954 Code, it would no longer be "tax-free"[9] and, hence, the business-purpose question is not really very likely to be raised. Similarly, under the 1939 Code a recapitalization wherein common shareholders turned in a part of their common in exchange for a new preferred which they then sold to a third party who redeemed it might convert ordinary dividend income into capital gains,[10] *if* they could support a business purpose for the exchange. Under the 1954 Code, such an exchange would result in Section 306 stock, and the shareholders would be charged with ordinary income just as if the sales proceeds had originally been distributed by way of an ordinary dividend.[11] It is well to remember, however, that the tax authorities can argue "no business purpose" to meet any new situation which they consider (rightly or wrongly) to be an abuse of the tax-free recapitalization provisions. If the taxpayer's objectives can be accomplished by a stock dividend, then use of the stock dividend method will eliminate at least this one argument from the Government's arsenal.

Common on common

A stock dividend on common may be in the same common, in nonvoting common, in stock rights of some kind, or in preferred stock. For each, there is no immediate tax.[12] Strictly speaking, perhaps, the dividend of voting common on voting common has no effect whatsoever. It merely gives the shareholder two pieces of paper instead of one to represent exactly the same values and rights as was represented by the one. As a practical matter, however, where there is a market for the stock the two pieces of paper generally turn out to be worth slightly more *on the market* than the one which they replaced.

A dividend of nonvoting common on ordinary voting common may be useful for both the corporation and its shareholders. For example, suppose: a major shareholder is approaching retirement age; his son is working in the business; his daughter's husband is not interested in it; and the corporate shares comprise a substantial part of his estate. While he desires to treat his two children equally, he feels it would be unwise, from the corporate viewpoint, to place any significant amount of voting stock in the hands of the daughter and son-in-law. The existing shareholdings can be divided into half voting common and half nonvoting common so that the voting common can be given or bequeathed to the son and the nonvoting common given or bequeathed to the daughter.

Similarly, in large estates where it appears that there will be no practical way to pay death taxes except by selling a substantial part of the shares in the family business, the dividend of nonvoting common or common may provide a security which can be sold without removing control of the business from the family. Or, the nonvoting common may be donated, either at death or before death, to a qualified charity or charitable foundation. This method can reduce the death taxes to a manageable amount without jeopardizing family control of the business and without burdening the business with a heavy fixed dividend which might be required if preferred stock were used for either of these purposes.

Preferred on common—Section 306

Although no immediate tax results from a dividend of preferred on common,[13] there must be an allocation of basis between the old common and the new preferred in proportion to the relative fair market values of each immediately upon issue[14] and, with insignificant exceptions, *the preferred is classified as Section 306 stock.* This classification as 306 stock is not a deterrent if the preferred is to be given to a charity or is to be transmitted only at death, since transmission at death removes the Section 306 taint. Note, however, that an inter vivos gift does not per se remove the Section 306 taint, although as a practical matter there may be exceptions even to this under Section 306(b). Suffice it to say, that a dividend of preferred on common should be declared only with a clear purpose as to what is to be done with the preferred, and a clear understanding of the tax consequences. Such planning and study will frequently, although by no means in every case, cause the parties involved to look for another method.

Despite Section 306 consequences, the issue of preferred stock, either as a dividend on, or in exchange for, outstanding common stock, may be extremely useful and should not be overlooked. For example, where it is desired to reduce the value of the common stock so that all or substantially all of it can be acquired by a new purchaser, use of this device may sometimes be the only practical way to bring the corporate worth and the purchaser's resources together.

Mention should be made of the odd situation in which a stock dividend is payable on preferred stock. It is hard to imagine occasion for this, except in payment of preferred dividends in arrears. As previously mentioned, to the extent that the dividend is in payment of preferred dividends for the current and immediately preceding year, it is taxable as if it were made in cash.[15] To the extent that such a dividend is in payment of preferred dividends for earlier years, there is no current tax, *but* the stock so distributed will be Section 306 stock to the extent of the corporation's accumu-

[*Mr. Teschner, an attorney, practices in Milwaukee, Wisconsin. The paper was prepared with the assistance of his associate, Dale L. Sorden.*]

or other casual disposition" of personal property. See also §1001(d).
[8] Regs., §1.368-2(e)(5).
[9] Section 354(a)(2).
[10] *Cf.* C. P. Chamberlin, 207 F2d 462 (6th Cir. 1953).
[11] Section 306(c)(1)(B).
[12] Section 305.
[13] Section 305.
[14] Section 307.
[15] Section 305(b)(1).

lated earnings and profits, or, in other words, to the extent that money so distributed would be taxable as an ordinary dividend. This is true even though the stock so distributed in payment of the preferred dividends is common stock, since it is only common issued with respect to common which is completely excepted from the Section 306 treatment.[16]

Common for nonvoting common

Turning now to the true recapitalization where there is actually an exchange between the corporation and its shareholders, the possibilities are almost limitless, and we will confine ourselves here to some of the ones most frequently found useful. First, consider some of the exchanges which can be made with respect to outstanding common stock.

Outstanding common can be exchanged with the corporation (or with anyone else) for nonvoting common. Ordinarily the shareholder would not be willing to do so unless he receives shares representing a larger percentage of the corporate equity in compensation for giving up voting rights, but this might nevertheless be desirable for all concerned in some family situations. Where only one of two or three major shareholders desires to give nonvoting common to a charity or to a child who is not going to participate in the business, an exchange between the corporation and him alone may be preferable to a general dividend. The nonvoting common will not be Section 306 stock and will preserve to its holder a share in the future capital growth of the corporation; neither of these results is ordinarily true of preferred stock.

Use of no-dividend common

Another variant is a stock which has all the attributes of the ordinary common except that it pays no dividends in cash; instead it receives either stock dividends or simply additional book credits toward value on liquidation or redemption. Devices of this nature have been increasingly used in recent years. They may not only preserve corporate working capital while providing cash dividends for shareholders who need them, but they may also give shareholders in high-income-tax brackets their share of the profits in a form not subject to current taxation but subject to capital gains taxation if the shareholder realizes the profits before his death by selling the dividend shares.

The practitioner who is able to free himself and his clients from dependence on tradition will find the common stock which pays no cash dividends very useful. Indeed the opportunities for minimizing taxes by this method are so good that the Treasury Department is attempting to restrict them. A proposed amendment to Section 1.305-2 of the Regulations was published in the Federal Register on July 10, 1956.[17] In it, the Commissioner says that the mere existence of two classes of stock, one receiving cash dividends and the other receiving stock dividends, is equivalent to an election to receive dividends in stock or in cash. It is, of course, standard law that a shareholder who has an election to receive a dividend in cash or in stock will be taxed as if he had received it in cash.[18] Formerly, the general opinion was that in the absence of extraordinary circumstances a waiver of a dividend before its declaration was effective to prevent constructive receipt, at least where the waiver was an essential condition precedent to the declaration because the corporation was actually financially unable to pay such a cash dividend to all of its shareholders.[19] It is true that the law ever since 1936 has treated a distribution in stock as a distribution in lieu of money and therefore taxable as an ordinary dividend if it is, at the *election* of *any* of the shareholders, *whether exercised before or after the declaration thereof,* payable either in stock or in property. However, the rule has been used only where the corporation was willing and able to pay the dividend in cash at the stockholder's choice. It has not been used where a corporation in fact would not have declared the cash dividend but for the waiver of its payment by the shareholders concerned. And it has not been thought that a dividend payable in cash on one class of shares would convert a stock dividend payable on a second class into a taxable dividend unless the holders of the stock-dividend class had a legal right by way of option or otherwise freely to convert their holdings into the class upon which cash dividends were paid. Now, however, if the proposed amendment to the Regulations is valid, it would seem to be a complete bar to arranging or rearranging the capital structure of a corporation in such a way that there will be these two types of common stock. It is certainly going to be argued that the proposed amendment would not only be unauthorized by the Code but also unconstitutional. However, until the rule is tested, we can only speculate. In the meantime, use of a separate class of common stock which pays stock dividends instead of cash dividends will have to be approached with the greatest caution.

Preferred for common

The exchange of preferred for outstanding common is probably the most useful recapitalization device in the small-to-medium-size close corporation. Consider the familiar situation. A corporation has been operating for 30 or 40 years; its founders are approaching their middle sixties. Some or all of them have sons who have come into the business. The younger generation is finding fault with the older management for its lack of aggressiveness. Perhaps the sons foresee, on the death of the fathers, a distribution of the stock so that brothers-in-law or others not connected with the management of the company will come into substantial control or will at least be put in the position of reaping a substantial part of the benefits of successful management. The older shareholders, on the other hand, want the company to continue as it is, taking minimum risks. They want fixed dividends because they either have or are planning to reduce their salaried work. There may even be a widow or two, very concerned about any planned expansion or additional risk-taking. She desires security.

The preferred-stock recapitalization may be the best possible answer. The corporation amends its charter to provide for a good sound preferred stock with assured dividends and preference on liquidation. After the stock has been authorized, the older shareholders enter into a plan of recapitalization with the corporation whereby they agree to exchange all their common stock for the appropriate number of new shares of the preferred stock. The common stock must, of course, be carefully valued to set the exchange ratio. The younger management group does not participate in this exchange. Therefore, after the exchange has been completed, they are in complete management control of the corporation. The older shareholders have achieved what they want—security. They have frozen their equity values in

[16] Section 306(c)(1)(A).
[17] See JTAX.
[18] Section 305(a)(2).
[19] Rev. Rul. 45, IRB 1953-7, 6.
[20] Section 368(a)(1)(E); §354.
[21] Section 1014.

a preferred position where they have a first call on profits and a first call on assets in the event of liquidation; if the younger management guesses wrong and the company goes downhill, at least the older shareholders get what is left. The younger management group now has not only complete voting control, but if they guess right and the company does expand they will receive the full benefits of the expansion.

There is no immediate tax on this type of a recapitalization.[20] For that reason, it has a substantial tax advantage over redeeming shares held by older stockholders either for cash or for some sort of debt. If the older shareholders continue to hold their preferred stock until death, the shares will acquire a new basis[21] and the gain never will be taxed.

Section 306 in a recapitalization

One big question in this type of recapitalization is: when is Section 306 applicable? According to Section 306(c), "Section 306 stock" includes preferred stock received in a tax-free recapitalization or other reorganization "to the extent that . . . the effect of the transaction was substantially the same as the receipt of the stock dividend." The Regulations amplify this statement considerably. The short answer seems to be that you look at what would have happened if the exchanging shareholder had redeemed his common instead of exchanging it for preferred. If under Section 302 the redemption would have been treated as a dividend—because of the attribution rules of Section 318, generally—then the preferred received in exchange will be Section 306 stock. But if the hypothetical redemption would have been treated as a capital gain transaction, then the preferred received in exchange will not be treated as Section 306 stock. Generally speaking, if the exchanging shareholder has a son who will continue to hold common stock, then, by reason of the attribution rules, the preferred stock he receives in the exchange will be 306 stock because had he instead redeemed his common stock, it would have been treated as a dividend under Section 302. If on the other hand the exchanging shareholder is not related to the continuing common shareholders under Section 318(a), then he could have redeemed his common stock for cash and had it treated as a capital gains transaction; consequently, the preferred stock on the basis of statutory logic should not be treated as Section 306 stock. No specific ruling has been found as yet on this point. This is a situation in which the tax planner must know how all of the shareholders concerned are related not only by family but by common interests in trusts, estates, other corporations and partnerships.

Even in the family situation where the preferred stock received by the older shareholders will be Section 306 stock, this fact should not ordinarily be a deterrent since the whole purpose of the transaction will normally be to provide the retiring shareholders with an income producing security which they can use for retirement and will hold until their death. On death, of course, the taint of Section 306 is removed.

One thing which must be kept in mind is that the exchange of common for preferred must be with the corporation and not between shareholders. In other words, you cannot simply declare a dividend of preferred on common and then have the older and younger shareholders exchange among themselves so that the older shareholders end up with the preferred stock and the younger shareholders with the common. Under Section 1036, a tax-free exchange between shareholders is possible where it is common for common (voting for nonvoting for example) or where it is preferred for preferred, but not where it is preferred for common or vice versa. An exchange of common for preferred is tax-free only if it can be brought within the rules of Section 354. Section 354 requires that there be a reorganization and reorganization requires a recapitalization, not a mere stock dividend.

Participating preferred

In considering a preferred-stock recapitalization to give security to older shareholders and control and incentive to the younger managers, do not forget that a preferred stock does not necessarily have to be absolutely fixed in value. It is perfectly possible to create a preferred stock which shares to some extent in the capital growth of the corporation either by way of participating dividends or by way of a liquidation value which shares in some ratio with the common in the corporate growth. While such a participating preferred is not as desirable from the standpoint of the young managers, it may be necessary in order to persuade the older shareholders to make the exchange.

It is hardly necessary to say that preferred stock can be a substantial burden on a corporation. Therefore in the ordinary case there should be some provision either in the charter or in a contract between the holder and the corporation to provide for its eventual redemption. This is not tax law; it is merely good corporate planning. There is one point of tax law, however, that should be considered. If the stock is Section 306 stock, it could be disastrous to the exchanging shareholder to give the corporation a right to call the shares during his lifetime; consequently, the period of no call should be calculated to exceed by a reasonably safe margin the life expectancy of the exchanging shareholders.

Stock for debt

An exchange of stock for debt is the last category of recapitalization exchanges. Under the 1939 Code, such an exchange could classify as a nontaxable recapitalization if there was sufficient business purpose. However, Sections 354(a)(2) and 356 of the 1954 Code provide that to the extent the principal amount of securities received exceeds the principal amount of securities surrendered, gain will be recognized. Loss, however, will not be recognized under Section 356(c). The only debt recapitalization which can be effected tax-free is an exchange of debt for debt bearing a different interest rate or different terms but in the same principal amount. Debt, of course, may be exchanged for stock and this downgrading may be accomplished tax-free. Similarly, an exchange of outstanding preferred for common will be tax-free.

One other situation which deserves mention involves the term trust. As you all know, the term trust has become one of the most useful, if not the most useful, legitimate devices in lifetime estate planning for the ordinary business and professional man. He can transfer income-producing securities to a trust for another term of years, freeing himself of the income while he is in high brackets because of his salary and yet recover the property later. It often happens that shareholders could make excellent use of a term trust but for the fact that substantially all of their assets are invested in the company and the company is in no position to pay cash dividends commensurate with the true value of the stock. A conversion of a part of the stock value of the company from common to preferred may solve the problem of what is to be put into the term trust.

The corporation may very well be able to pay dividends commensurate with value on a reasonably small amount of preferred stock even though it could not pay such dividends on its total stock. The simplest thing to do here is to declare a dividend of preferred on the existing common, but if it is not desirable to distribute the preferred to all the shareholders then the same thing can be achieved as to particular shareholders by a recapitalization exchange. In most cases, the resulting preferred will be Section 306 stock, but since no taxable disposition of it is contemplated this is not a deterrent.

If the preferred is to be distributed to some of the shareholders by means of a recapitalization rather than to all of the shareholders, then the remaining shareholders may require that the exchanging shareholder surrender common of a value somewhat in excess of the preferred he will receive. The income tax advantages of the term trust will generally outweigh any disadvantage resulting from a slight disparity of value. In any event, if the preferred is made convertible back into common at the original ratio at the option of the holder after a period of some years, then the disparity will be of little or no consequence. Such a reconversion ratio could even take into account any differences in dividends that have been paid on the preferred and common in the interim. Such details are a matter for negotiation and examination in the particular case. The point here is that the possibility of using a recapitalization or stock dividend to provide a security suitable for use in term trusts should not be overlooked.

Mechanics of recapitalization

Very little needs to be said here on how to recapitalize. Shareholder action is, of course, required to amend the charter and you are all familiar with the procedures. In many instances directors will have the legal authority for a particular recapitalization because of authorized but unissued shares already available. In that event preemptive rights may or may not be involved. In any case, however, the desirability of effecting a recapitalization by directors' action alone is questionable and in most instances shareholder action should be insisted upon. The fiduciary relationship between the directors and the non-director shareholders should cause the attorney to insist upon shareholder action.

Like any other reorganization a recapitalization is supposed to be contained in a "plan."[21] The plan should be in writing, and should be made a part of the permanent records of the corporation. It is true that there are cases which say that a plan of reorganization may be informal or even oral but the existence of these cases is certainly not a reason deliberately to fail to carry out the formalities. Proper corporate meetings should be held. In recent months there appears to have been a marked increase in the attention given by the Internal Revenue Service and even by its Intelligence Unit to investigating the bona fides of minutes of corporate meetings which spell out plans or reorganization, liquidation and other actions which have the effect of postponing recognition of gain or loss. It seems only prudent actually to hold the necessary meetings so that at a later date, if challenged, the persons involved can honestly and affirmatively testify that the minutes truly represent the actions taken. As for the formalities of notice and records under the Internal Revenue Code, Section 1.368-3 spells these out in considerable detail.

The prime use of favorable aspects of recapitalizations, particularly preferred stock recapitalizations, is to transfer value or control or both with minimum or no tax consequences. The greatest danger is Section 306 implications. Certainly the "related persons" provisions of Section 318(a) should be carefully weighed and understood before any reorganization, recapitalization or stock dividend, other than common on common is undertaken. Where an exchange is contemplated which involves the receipt of some cash, debt instruments or other property in addition to stock of the exchanging corporation, the danger that the exchanging shareholders may be charged with having received ordinary dividend income if there is any attribution of ownership between them and the remaining common shareholders under the Section 318(a) provisions should not be overlooked. Nevertheless, a use of stock dividends and recapitalizations which is at once imaginative and intelligent can provide solutions to problems of sales and retirements, to problems of shifting control or value, which may seem otherwise insoluble. Particularly in connection with the small-and-medium-sized business, this is an area in which the taxman can be of great service by taking the initiative and proposing action. ☆

Section 533 may endanger close corporation which holds stock for executives

In the November 1956 issue we discussed a plan under which the key officers and employees of a large corporation could acquire stock of their employer through the formation of a new corporation. This corporation would purchase the stock under a contract calling for annual payments approximately equivalent to the dividends expected to be received on the stock.

The editors of *The Tax Barometer* wrote us suggesting the possibility that such a corporation would be subject to the accumulated earnings tax under Section 533(b). They referred us to the case of *Beim Co. v. Landy,* 113 F.2d 897.

The accumulated earnings tax amounts to 27½% on the first $100,000 of accumulated taxable income. In the example in the November issue, the effective tax would, because of the deductibility of interest paid, be less than the 30% normal tax paid by corporations, and substantially less than the highest bracket of the individual shareholders. In the same example, the accumulated earnings surtax might be imposed during the second year of the corporation's existence.

Under normal circumstances, the accumulated earnings tax is not asserted in any case where the corporation has no cash available and has substantial obligations. Such would be the situation in this case up to the point the stock has been fully paid for; however, while there is no case directly in point, the *Beim* case indicates that the normal defense that earnings are needed to meet obligations would be overcome by a finding that this is a mere holding or investment company.

Under Section 533(b) the fact that a corporation is a mere holding or investment company is prima facie evidence of the purpose to avoid the in-

come tax on its shareholders. In the *Beim* case, a husband and wife had a contract to buy certain stock; they assigned the contract to a wholly-owned corporation which used the dividends to make the payments. The Commissioner asserted the accumulated earnings surtax. Upholding the Commissioner, the court held that the individuals remained liable on the contract, and that the sole purpose of the corporation was to use its earnings to satisfy an obligation of the stockholders.

Where the accumulated earnings are to exceed $60,000, it might be advisable to have the corporation perform certain functions other than those of a mere holding or investment company. The performance of educational or research activities might well take it out of this category. It might also operate a small business related to that of the principal corporation.

Under Section 535(c)(3), even a mere holding or investment company is allowed the $60,000 credit. A plan of this type would, of course, not run the risk of this tax in any situation where not more than $60,000 of dividends would be needed to make payments. ☆

New Ruling holds redeemable nonvoting stock is 306 stock

PRACTITIONERS ARE WARY of stock dividends other than common on common; clearly, any preferred stock dividend is 306 stock and proceeds of sale are ordinary income. But 306 applies also to the "stock which is not common stock" received in certain reorganizations. There has been a popular assumption that nonvoting common stock is free of the taint of Section 306, and hence may be sold or redeemed without fear of ordinary income treatment under that section. Such complacent assumptions were recently shattered by *Rev. Rul.* 57-132 (1957-14 IRB, p. 7, April 8, 1957) which holds that *redeemable* nonvoting common stock constitutes Section 306 stock.

The nonvoting common, together with new voting common, was issued in a recapitalization under Section 368(a)(1)(E) on a pro rata basis to the present holders of the outstanding common. There evidently was no doubt that the exchange was tax-free; the sole problem related to the nature of the new nonvoting common for purpose of future disposition of the stock. This stock was identical in all respects to the voting common stock, except the absence of voting rights plus the vital difference that it was redeemable at the discretion of the corporation at a price equal to 110% of its book value.

It was the redemption feature that provided the Section 306 taint according to *Rev. Rul.* 57-132, since this made it more akin to preferred stock.

In passing, tax men have noted there are other unusual situations where common stock may be classified as Section 306 stock. Thus, the Regulations (Section 1.306-3(e)) supply the example of common stock which is received in a Section 351 corporate organization (transfer to a controlled corporation) in exchange for Section 306 preferred stock. Such new common stock retains the curse of Section 306. Before proceeding with a recapitalization, or a tax free dividend or even a simple exchange of stock under Section 1036, (stock for stock of the same corporation) the cautious tax advisor will make certain the common stock to be received cannot be classified under Section 306. ☆

New corporate decisions this month

Notes to owners on incorporation of partnership held really capital [*Certiorari denied*]. The Tax Court found that no real creditor-debtor relationship was established between a corporation and a husband and wife, its chief officers and stockholders. Upon formation, the corporation had issued stock of $49,000 and notes to stockholders of about $232,000 for partnership assets worth $281,000. All other corporate debts were given preference by subordination of stockholder loans. Some of the stockholder loans were not paid at maturity. The Tax Court disallowed the interest deduction; payments to stockholders were, it held, distributions of corporate profits taxable as dividend income. The Eighth Circuit held that the question was one of fact and said that the Tax Court decision was supported by the evidence. One circuit court judge dissented: everyone, including banks and other creditors, treated the notes as real indebtedness. He found no support for the Tax Court's disregard of the liability. *Gooding Amusement Co., cert. den.* 3/11/57.

Property was paid in as loan despite book record as capital; bookkeeper treated it as paid-in surplus. Taxpayers incorporated a business previously operated as a partnership. The corporation issued $300,000 of stock and $150,000 of notes for the assets. Since it was known that the assets were worth more, the partners were given a right to take the excess as either stock or notes. The excess value, some $90,000, was treated by the accountant as paid-in surplus and, upon repayment, as a dividend. Noting that the taxpayers had been educated in Europe and were unfamiliar with American financial terms, the court finds they intended the excess to be debt. *Moll,* DC Ohio, 2/25/57.

Debt-to-capital ratio of 600 to 1 too thin. Taxpayer-corporation was organized by five individuals to acquire title to and operate rental property. Of the $150,000 required over and above the mortgages to purchase the properties, $3,000 was received for stock and $147,000 as advances from the stockholders in amounts proportionate to their equities. Additional sums were later advanced in like proportions as working capital. No written notes were issued to evidence the advances and no fixed date of repayment was specified. The Tax Court noted that the ratio of debt to capital was 600 to 1, and refused to permit a deduction for the amounts accrued as interest on these purported loans. The circuit court affirms. *241 Corporation,* CA-2, 3/28/57.

Jury finds loan by luggage manufacturer to movie producer nonbusiness. Taxpayer, a partnership engaged in the manufacturing of luggage, loaned $75,000 to a film-producing corporation. Taxpayer was to receive interest on the loan and a share of the profits. The partners had amended their partnership contract two years previously to indicate their agreement to engage in the business of financing motion-picture productions. The loan became worthless within a year. The jury found that taxpayer was not in the business of financing motion-picture ventures in the year in which the loss was sustained, the loss is a nonbusiness bad debt. *Koch,* DC Cal., 1/23/57.

Loss on stock sale allowed though relative subsequently buys it. Taxpayer was a member of a partnership which held stock in a Miami hotel. The stock was sold back to the hotel for one dollar, and taxpayer claimed a loss. The Tax Court allowed the loss, though the Com-

missioner argued that it was indirectly a loss on a sale to a related person because, as was planned, the stock was resold by the hotel to a relative of the taxpayer. This court affirms the Tax Court finding that there was no sale, direct or indirect, to the relative. The sale was to the corporation. *Lincoln,* CA-6, 3/1/57.

District court reversed: redemption of stock is equivalent to a dividend. Taxpayer was sole stockholder in a corporation primarily engaged in the real estate business. In 1945 and 1946, the corporation disposed of several parcels of real estate. In 1946, the corporation purchased from the taxpayer one-half the total outstanding stock of the corporation. The district court held that there was a business purpose for the sale of the stock (presumably the contraction of the corporation's business) and the transaction resulted in a capital gain to the taxpayer. This court reverses; it reviews the criteria other cases have established for determining whether a distribution is substantially equivalent to a dividend. It finds no corporate contraction, no corporate business purpose and, most important, that the net effect was the same as a dividend. [The 1954 Code exempts from taxation as a dividend distributions not substantially equivalent to a dividend and in addition provides for exemption of several specific redemptions. *Ed.*] *Woodlaw,* CA-9, 2/28/57.

"Loans" to stockholder of closely held corporation were dividends. Taxpayers, husband and wife, contended that moneys withdrawn by the husband in 1946, '47 and '48 from the closely held corporations they controlled were loans which were later repaid in 1949 and 1950. The court holds that the moneys withdrawn were dividends; they were received by the husband out of earnings and profits. The repayment of the "loans" was a contribution to capital and increased taxpayers' basis. *Stoddard,* DC Tex., 2/57.

Distribution of subsidiary stock in a splitoff fails to qualify as non-taxable. Prior to corporate shifts taxpayer owned half of a parent company and half of another company. After the shift he owned all of the former subsidiary and nothing else. The mechanism used was first a merger of the parent with the other company. This the Ruling states was for bona fide business reasons. Then taxpayer turned in his stock in the merged company and received all the stock of the subsidiary. The Service holds the two transactions must be viewed together. Based on the values of the stocks involved, taxpayer received the subsidiary one-third for his interest in its parent (taxable exchange) and two-thirds for his interest in the other corporation (taxable because the subsidiary shares received did not have control (80%) of the subsidiary). *Rev. Rul.* 57-114.

Spinoff tax-free though one of separate businesses relatively inactive. A cooperative association marketing fresh fruit transacted very little fruit business from 1951 to 1956 because of a series of disastrous freezes. In 1951, it installed and operated a cotton-compressing business to offset the fruit losses. All assets of the cotton-compressing business were transferred for bona fide business reasons to a new corporation in exchange for stock which it then distributed to its members. The spinoff is held to qualify as a tax-free divisive reorganization. Even though the fresh-fruit business was relatively dormant it constituted the "active conduct of a trade or business" for a five-year period, since the separate identity of the fresh-fruit division was retained and full-scale operation was resumed. *Rev. Rul.* 57-126.

No taint on Section 306 stock in absence of tax-avoidance plan. A publicly held corporation for bona fide business reasons acquired, in a nontaxable reorganization, all the assets of a closely held corporation with only common stock in return for 5% of its outstanding voting preferred and common. The Service holds that the preferred constitutes Section 306 stock. The Code specifically provides that the disposition of 306 stock is the sale of a capital asset if it is established that the distribution and disposition are not in avoidance of tax. In this case, gain or loss on its sale or other disposition will not be treated as ordinary income since the issuance was not in pursuance of a tax-avoidance plan. *Rev. Rul.* 57-103.

Predecessor's error in determining basis does not bind taxpayer receiving asset in reorganization. Taxpayer's predecessor did not report on its tax returns any gain derived in 1925 from its exchange of stock for certain properties, although the exchange was in fact a taxable transaction. Taxpayer-corporation later acquired the properties in a nontaxable reorganization and sold them in 1945. The court holds taxpayer's basis for the properties was equal to the value of the stock exchanged for them back in 1925. The fact that taxpayer's predecessor treated that exchange as though no gain or loss resulted did not prevent taxpayer, either by equitable estoppel or by a duty of consistency, from correctly computing the basis on subsequent sale. *The Manhattan Building Co.* 27 TC No. 127.

Corporation 80% controlled at transfer despite subsequent issue to others. Taxpayer transferred patents to a corporation in exchange for more than 80% of its stock, but two months later, and before the shares were issued, he caused more than 20% of the stock to be issued to certain of his creditors. The court holds the subsequent transfer to the creditors could not obviate the application of 1939 Code Section 112(b)(5) which provides that no gain or loss is recognizable upon a transfer of property to a corporation 80% or more of whose stock is owned by the transferor immediately after the transfer. Accordingly the basis of the patents to the corporation was the same as that of the taxpayer. *O'Conner,* TCM 1957-50.

Nonvoting common is "Section 306" stock. Under a plan of recapitalization, a corporation issued new voting common and new nonvoting common in exchange for its outstanding common stock. The only other difference between the voting and the nonvoting was that the nonvoting was redeemable at the discretion of the corporation. Because of the redemption feature, the nonvoting stock is held to be Section 306 stock. [See comment, page 327. *Ed.*] *Rev. Rul.* 57-132.

Corporation taxed on stockholder's sale of property it gave him. Taxpayer-corporation made a gift of fully depreciated machinery to its principal stockholder and also sold some machinery to him at book value. He sold the machinery at a profit. The Commissioner taxed the corporation for this profit, and the court upholds this treatment. The corporation carried the various machines on its books, and paid personal property taxes thereon, until sold. The court holds that the stockholders cannot repudiate the corporate identity for tax purposes. *K.*

O. Lee Co., Inc., DC S. Dak., 2/27/57.

Jury finds no improper accumulation of surplus. The court instructed the jury to consider the nature of the business, the financial condition of the corporation at the close of the taxable year, the use of the undistributed earnings, and the intentions of the directors. Events before and subsequent could be considered in determining motivation during the years in question, but the court also advised that changes in conditions may alter plans. The facts of the case are not reported. The jury holds that profits had not been accumulated beyond the reasonable needs of the business during any of the years in question. *Bradford-Wonderly Investment Co.*, DC Cal., 12/6/56.

Incentive salary of $81,000 reasonable. The vice president of taxpayer corporation, together with his wife owned 50% of the stock. The other half was owned by the president and his daughter. The business was plumbing contracting and little capital was required. The vice president brought in most of the business and was dissatisfied with an equal split of profit. In order to retain his services the corporation adopted an incentive compensation plan. On each contract closed the corporation would keep 10% of the gross price, not less than $1,000, the rest would be salary of the officer in charge of the job.

Under the plan the vice president earned $38,000 the first year and $81,000 the second, the year here in review. The Commissioner allowed only $40,000 of the $81,000. The court holds that the plan was reasonable when adopted and that it was not shown that circumstances had changed. It allows the full $81,000. *James J. McHale Company*, DC Ohio, 3/22/57.

Stockholder ignored corporate entity; dividend credit allowed for assets appropriated [*Acquiescence*]. Taxpayer contended that although it was a corporation in form, in truth and fact it was the alter ego of one Jordan, its 98% stockholder, and was therefore not liable for any corporate income tax. The Tax Court held otherwise. Although taxpayer was a personal holding company, no liability for the personal holding company surtax exists because the corporate income was distributed to Jordan as it was received and such distributions qualified for the dividends-paid credit. *Sebago Lumber Co.*, 26 TC No. 137, acq. IRB 1957-6.

Liquidation occurred within 12 months despite prior sale of assets. A publicly owned corporation sold a separate business division in 1954 at a time when liquidation was not contemplated. During 1955 the officers and directors decided to dispose of the remaining assets and business, and liquidate the corporation completely. The stockholders adopted a resolution to that effect on December 15, 1955. For purposes of Section 337 the Service holds the corporation may liquidate within 12 months after December 5, 1955, the date the stockholders adopted the plan of liquidation, without realizing any gain or loss on the subsequent sale. The sales in 1954 were not in accord with any formal or informal plan of liquidation; therefore the 12-month period is measured from the date of adoption of the plan. *Rev. Rul.* 57-140.

Court hints Section 337 may be inapplicable if assets go to creditors in liquidation. Three public utility companies, insolvent since 1930, proposed a reorganization under Chapter X of the Bankruptcy Act. The plan provided a selling price ($8 million), substantially in excess of the basis of the assets. Upon request by the trustees for the companies, the Commissioner ruled that the corporate gain would be recognized since all distributions would go to the creditors. Section 337 would exempt gain on assets sold in the course of a 12-month liquidation. However, the Commissioner interpreted the Section 337 phrase that "all assets . . . are distributed in complete liquidation" to mean distribution to *stockholders* in redemption of stock. The court refuses to determine whether the Commissioner is correct. This proceeding is litigation of a proposed plan and is in effect a request for a determination of a hypothetical question. However, the circuit court points out that Section 337 had its origin in the *Court Holding Co.* (324 U.S. 331) and the *Cumberland Public Service Co.* (338 U.S. 45) cases, wherein the question was whether property was sold by a corporation or its stockholders. The inference is that the Commissioner's ruling may be justified by the legislative history. *Inland Gas Corp.*, CA-6, 2/14/57.

Redemption no dividend; beneficial interest terminated (old law) [*Acquiescence*]. The Tax Court found that redemption of taxpayer's stock ended his interest in the corporation; he had no beneficial interest in some shares in his name. It therefore ruled that the redemption was not equivalent to a dividend. [The 1954 Code specifically provides that certain complete terminations of interest by redemption are not equivalent to a dividend. *Ed.*] *Tiffany*, 16 TC 1443, *acq.* 1957-6.

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Failure to file PHC return reasonable. Taxpayer claimed that its failure to file a personal holding company return was due to ignorance. In audits of prior years, agents had never discovered the error. The court finds the failure was due to reasonable cause, even though taxpayer did not seek the advice of a lawyer or accountant. The court holds that the penalty imposed for nonfiling should be refunded. *K. O. Lee Co.*, DC S. Dak., 2/27/57.

Total income from patent licensees is PHC income. Taxpayer, all of whose income came from patent licensees, contended that less than 80% of its gross income for the years in question was personal holding company income because a stated percentage of the royalties received represented payments for engineering and other services rendered to the licensees. The court disagrees since there was no agreement or understanding that the corporation should furnish the licensees with any services. The entire amount received was therefore royalty income, thereby making the company a personal holding company. Because it did not show that advice of counsel was sought or relied on in determining whether it should file a personal holding company return, penalties for failure to file are sustained. *O'Connor*, TCM 1957-50.

Gains from commodity futures are PHC income; can't net gains and losses under old Code. Two corporations engaged in a wide variety of commodity-futures transactions contended that the gains derived did not qualify as personal holding company income because the futures were "bona fide hedging" transactions which resulted in ordinary business income. The court finds, however, that neither of the corporations produced, processed, graded, stored, transported, or otherwise handled any of the "active" commodities which they bought and sold. The gains were therefore personal holding company income. Furthermore, in determining the gross income test under the 1939 Code, the court states that gains are includible without reduction for any capital losses. The 1954 Code provision permitting a netting of capital gains and losses was not to be applied retroactively. *Sicanoff Vegetable Oil Corp.*, 27 TC No. 129.

Sole shareholder gives shares to settle debt; redemption a dividend to him. Taxpayer, the sole stockholder of a corporation, transferred a portion of his stock to a third party in settlement of a personal agreement. The latter then sold the stock to the corporation for $20,000. The Tax Court held that the corporate payment of $20,000 was in discharge of taxpayer's obligation in like amount and accordingly taxpayer received a dividend of $20,000. This court affirms. *Ferro*, CA-3, 3/20/57.

No dividend on redemption of part of trust's stock; another was buying remainder to eliminate holding [*Acquiescence*]. Taxpayer had transferred to a trust part of his half interest in two Chevrolet dealership corporations and his one-third interest in a third corporation. Upon insistence of the Chevrolet Motor Division that the trust be eliminated as a shareholder, the corporation adopted this plan: the corporation would redeem part of the trust shares, taxpayer would buy the rest from the trust, and the corporation would redeem enough of other holders' to restore taxpayer's interests. As to the redemption of the trust shares, the court holds the transaction represented a first step in an integrated plan to eliminate the trust completely, and therefore constituted a purchase of stock rather than the payment of a dividend. However, the distributions to the individuals are held to constitute dividends under Section 115(g) of the 1939 Code. *Howell, (Kenyon Trust), acq.* IRB 1957-6.

EPT accrues for operating loss despite later refund. In 1946, taxpayer suffered a loss; in computing the loss carryback, it deducted under the Code provision permitting deduction of excess profits tax paid or accrued in that year, additional excess profits tax for 1942, 1943 and 1944 on the ground that these additional taxes accrued in 1946 when taxpayer reached a settlement with the Service and signed an 874. The court concurs. Taxpayer recognized the liability then; prior thereto it was contesting it. The fact that taxpayer later filed claim for refund does not affect the 1946 accrual. The settlement of the claim (taxpayer collected part) was made in 1947. *Landers, Frary & Clark*, Ct. Cls., 3/6/57.

Ten-year rule not applicable to constructive ownership by estate of beneficiary's holding. Section 302(c) provides that some indirect ownership rules of Section 318 do not apply if the redeemed stock had not been acquired within ten years from certain closely related persons and if the redemption effects a complete termination of interest (other than as creditors) for ten years thereafter. The Service points out that this ten-years-before-and-after exception applies only to Section 318 *family* constructive-ownership rules. The exception does not apply to the rule in Section 318 that stock owned by the beneficiary of an estate is deemed owned by an estate. It follows that if a corporation redeems stock held by an estate (no matter for how long) and if beneficiaries of the estate are themselves shareholders, the redemption is not a complete termination of interest; the estate still owns indirectly the beneficiaries' holdings. This attribution cannot come under the exception provided by the ten-year rule. *Spec. Rul.* 3/8/57.

$25,000 surtax exemption and EPT credit denied on tax-motivated splitoff. A corporation engaged in storage of petroleum organized taxpayer, and transferred several oil tanks to it in return for all its stock. The splitoff was motivated by the desire of the parent to minimize renegotiation difficulties by separating the government work, which it continued to handle, from general commercial operations, which were transferred to the subsidiary. The Tax Court denied the subsidiary the extra surtax exemption and the $25,000 minimum excess-profits-tax credit, relying on Section 15(c) of the 1939 Code. This section denies surtax exemption and the minimum credit to a newly-created corporation taking property from another controlled by the same interests unless the new corporation shows that securing the exemption or credit was not a major purpose. Taxpayer here failed to show that obtaining the exemption and credit was not a major purpose for the splitoff. This court affirms. *Coastal Oil Storage Co.*, CA-4, 3/11/57.

Cash-basis personal holding company can't deduct taxes applicable to prior year. In computing its personal holding-company tax for 1950, a cash-basis corporation cannot deduct the portion of its 1949 income tax liability which was paid in 1950. The penalty surtax applies to the income remaining after dividend disbursements and tax payments applicable to the taxable year. *Patten Fine Papers, Inc.*, 27 TC No. 94.

TAX STRATEGY NEWS OF THE REVENUE SERVICE

Effective tax procedures

EDITED BY MARTIN M. LORE, LL.B. CPA

Congressional Subcommittee urges many changes in operation of Revenue Service

REPRESENTATIVE WILBUR MILLS' Subcommittee on Internal Revenue Taxation has just released a number of recommendations for change in operation of the Internal Revenue Service which would have far-reaching effects on practitioners' work with the Service. The Mills' committee report takes into consideration the work of the Advisory Group of well-known practitioners (see names on page 334) appointed to advise the subcommittee.

The work of the advisory group and the subcommittee provides a wealth of information of direct and important interest to tax practitioners. We report below the substance of the subcommittee's recommendations; in the next issue we will include material developed by the practitioners' Advisory Group which will give readers a number of insights into operation of the Service throughout the country.

The main points made by Mr. Mills' subcommittee are these:

Desire for "blue ribbon" service

More than 4 years have elapsed since the 1952 reorganization of the Service became effective. Sufficient time has elapsed and sufficient experience has been acquired to evaluate the effect of the reorganization in many respects and its administrative cost as compared with the system in effect prior to 1952.

The subcommittee's purpose in studying the administrative functions of the Service is to do whatever we can to make it possible for the Service to operate as a blue-ribbon service. This can be achieved only with the full cooperation of the Treasury Department, the Internal Revenue Service, the Congress, and the public. Such a Service, in the opinion of the subcommittee, must operate at top efficiency with a reputation for fairness, unquestioned integrity, and impartiality by revenue officials in order to obtain maximum voluntary compliance. By striving to make the Service a blue-ribbon service, we believe it will attract the highest type of civil servants for this important work. It should always be the rule to promote career employees on the basis of ability and efficiency as well as experience to vacancies occurring in the Service.

The most essential function of the Service is to determine, assess, and collect taxes. Any other activity which may hamper or retard this function should be re-evaluated to see if it is necessary. As a vital step in the process it is essential that the Service be impressed with the advisability of settling cases with a minimum of litigation. As was stated in an Advisory Committee report issued in 1927:

"The collection of revenue is primarily an administrative and not a judicial problem. As far as the Federal income tax is concerned, a field of administration has been turned into a legal battlefield."

We are glad to report that under the leadership of Commissioner Harrington, the Service has shown considerable improvement during the past year.

Reopening of cases

A material obstacle to settlement of tax cases is the knowledge on the part of the examining officer and the taxpayer that a case may be reopened after being closed by the Auditing Division. While a review of closed cases is desirable in the interest of uniformity, the reopening of cases where no fraud or collusion is involved appears to be unjustified.

Under the present operation closed cases are subject to several reviews. One review is by the regional analyst who reviews on a selective basis taxpayer settlement files: to determine (1) whether the settlements have been based on a proper interpretation of the law; and (2) the adequacy of the audit procedures.

Another review which may lead to the reopening of cases is that of the Internal Audit Division of the Inspection Service. This activity is outside the operations line of authority and is under the Assistant Commissioner (Inspection).

The Service advises that review of a technical issue in a closed case is not a proper function of Inspection Service employees but that reopenings may have been caused in the reorganizational processes by reason of excessive zeal or misunderstanding of their functions.

However, the subcommittee believes that the existence of a review of closed cases outside the examining officer's own chain of command has a tendency to prevent the exercise of independent judgment by the examining officer. Furthermore, it also affects the taxpayer's willingness to settle if he knows that the settlement may be upset even on a minor point without the examining officer's line of command.

Responsibility of the commissioner

The subcommittee views with concern the fact that farflung decentralization may have the effect of causing the Commissioner to lose control of the organization under the authority delegated to him by the Secretary of the Treasury. He must at all times have such contacts with the field as will enable him to keep abreast of field operations and see that the tax laws are administered fairly, promptly, uniformly, and equitably.

The subcommittee feels that since reorganization of the Service too much responsibility has been shifted from the Commissioner down into the field. We feel that more of the responsibility for the operation of the Service should be in the Commissioner.

The tendency at present is to make the national office more of a managerial agency than an agency responsible for decisions made. It is believed that there has been an excessive redelegation to the field by the Commissioner in various areas. To aid the Commissioner in assuming responsibility for the operation of the Service, the subcommittee recommends that the Congress provide by statute that if the Secretary of the Treasury delegates or redelegates any powers conferred upon him with respect to the determination, assessment, and collection of internal revenue taxes, such dele-

gation or redelegation as the case may be, shall be made by the Secretary to the Commissioner. An exception to this rule shall be the power to prescribe Regulations, which the Secretary may at his discretion delegate or redelegate either to the Commissioner or some other Treasury official. The Commissioner will, of course, retain his right to redelegate such powers to the field as will not interfere with his responsibility for the administration and operation of the Service.

Chief Counsel

The subcommittee feels that the Chief Counsel should be restored to his former position as a statutory officer appointed by the President and confirmed by the Senate.

The Chief Counsel occupies one of the top positions of responsibility in the enforcement of the internal revenue laws. He is the law officer for the Service and should, therefore, be a statutory officer subject to confirmation of the Senate.

Regional Commissioner

The subcommittee believes the organization and operation of the Office of Regional Commissioner needs further study. In discussing the functions of the regional structure with your subcommittee the Commissioner stated:

"This organization is just about four years old and therefore there has been a certain amount of fuzziness as to just what these regional people should do. We know it has been pretty hard to define in altogether definite terms their responsibilities . . . I am trying to get the machine on the track and have the regional setup function as economically and as effectively as we possibly can make it. . . . All I can say to you now about this is that we are studying the problem and we will have a solution to it in the course of time . . ."

It is hoped that the Commissioner will report to the subcommittee the results of this study as soon as practicable together with some indication as to the cost of the regional structure and if it is his conclusion that these offices should be continued, justification therefor should be reported to the subcommittee.

The subcommittee is also aware of certain criticisms directed toward the physical boundaries of the Internal Revenue regions. It is stated that areas with similar physical characteristics have been divided and made part of different Internal Revenue regions. Taxpayers in one region are often treated differently from those in the adjoining region simply because there are not available in both offices experts capable of resolving issues which are unique to particular geographical areas. Where this occurs, uniformity suffers.

Separating collection, audit functions

In the field procedures there still appears to be possible changes for improving the Service. The audit of returns, which is the backbone of the entire revenue system, needs to be given a more independent status than is possible under the present system of combining collection and audit under each director. It is hoped that the Commissioner will give further study to placing the Audit Division under a different head. Either the determination or the collection function should be reassigned to another office coordinate with the district director and responsible to a higher level.

The Commissioner has already advised the subcommittee that he is giving further study to the present arrangement of postaudit review. The subcommittee is not convinced that the present practice of having a separate postaudit review in each of the nine regional commissioner's offices is desirable. It does not appear to create uniformity in the application of tax laws. It is hoped the Commissioner will study this arrangement and compare it with the possibility of a centralized postaudit review from the standpoint of effectiveness as well as from the standpoint of cost.

The situation is stated in the Advisory Group's report as follows:

"Most of the publicized criticism which has arisen since the reorganization of the Service has pertained to that part of the organization handling the audit of tax returns. Audit activities have, of course, been affected by national office decisions, personalities, policies, and innovations, by the consolidation of audit operations with intelligence and collection at the district level as well as by the introduction of the regional commissionership into the organizational scheme of the Service.

"We understand that the Audit Division of the district office is placed in a crossfire from above which is damaging to the self-respect and vigor of frontline supervisory officials engaged in directing the performance of the work. Inspection Service internal audits of the Audit Division are designed to insure rigid total compliance with procedures and directives regardless of their practicability. Regional analysts, on the other hand, visit the district audit installations purporting to seek out areas for improvement and helpful modification. District Audit supervisory officials can best satisfy the standards of the Inspection Service if they conduct audit operations as inflexible robots.

"The placing of audit activities under regional authority as well as the consolidation of audit activity with others at the district level continues to present one of the greatest problems attendant to the reorganization of the Service. The maintenance of this audit activity on a sound and efficient basis is so vital to the fiscal probity of our nation's economy, to the public's general respect for our Government and to the successful continuation of an effective self-assessment system providing the national revenues, that serious and objective inquiry should continue until adequate corrections or forthright solutions remove all real doubt as to the efficiency and vitality of this activity."

Informal conference procedure

The recently adopted informal conference procedure has lessened considerably the criticism of the old group chief review. This informal conference procedure revolves around what is known as a conference coordinator who will review protested cases and assign them to some person who, in his judgment, is competent to handle that particular case or that type of issue. The subcommittee wishes to commend the Commissioner for this important improvement in the settlement procedure. We hope that if further revision of the conference procedure is found necessary, the Commissioner will not hesitate to institute new policies.

Office audit

The subcommittee is of the opinion that the office audit procedure should be greatly expanded to cover a wider range of individual income tax returns and that an adequate clerical force to meet this expansion should be provided. It is believed that expansion of the office audits will provide a great potential source of additional revenue.

The Commissioner has indicated that he will give further consideration to this matter.

It is the opinion of the subcommittee that the Commissioner should give con-

sideration to the advisability of having a group of experts in a centralized location where advice of the group, as a group, can be given to the field. This may render unnecessary the duplication of the work of individual experts in the nine regional offices and produce greater uniformity.

Rulings procedure

Under decentralized operation, there are several questions of rulings procedure which the subcommittee believes deserves consideration and action.

In general, there is, properly, centralized in the national office the making of rulings and regulations establishing principles and policies for the interpretation and application of the tax laws, while decisions as to actual application of such rulings are made by field officers. It is recognized by the Service that application of rulings can be decided in the field contrary to national office policy, and that while field officers are reluctant to refer a question to the national office for fear their competence will be questioned, referral in such cases is encouraged. The Director has the right to ask the national office for interpretations, but the taxpayer has only the right to ask the Director to do so.

In the area of exempt-organization rulings, effort should be made to increase qualified staff for two purposes, i.e., first, expediting initial rulings as to exemption, and second, checking the operation to see if there is a continuing right to exemption.

In cases where for proper reason decision is made to refrain from ruling on certain issues, the Service advised that it will change its policy to announce to the public decisions to withhold rulings.

Certiorari to national office

The Service recognizes the value of granting certiorari to the national office in connection with the qualification of pension, annuity, profit-sharing and stock-bonus plans, and the status for exemption of related trusts. However, this special administrative procedure is not available in the case of other tax problems. At present any agent can refuse to request assistance from the national office as to a particular point at issue. The subcommittee recommends that where the taxpayer or his representative can establish that there is a lack of uniformity among Internal Revenue districts in deciding a particular issue the taxpayer should have the right to have the question referred to the national office on a certiorari basis.

The Advisory Group points out other special situations in which certiorari should be utilized. The Commissioner should give careful study to the advisability of extending the right of certiorari to such situations.

Ninety-day letter

The subcommittee believes that careful consideration should be given to the preparation of the 90-day letter which represents the last word of the Commissioner prior to the filing of a petition with the Tax Court. Your subcommittee has received complaints that the 90-day letter in some cases is not sufficiently informative to acquaint the taxpayer with the reasons or basis of the proposed deficiency.

The appellate staff issues all 90-day letters on cases that are handled by them and before being sent out are subject to legal review by the regional counsel. For those cases not sent to the appellate staff the 90-day letter is issued by the district director. It is hoped that the Commissioner will give consideration to having all 90-day letters issued by the appellate staff and reviewed by the regional counsel.

Appellate Division settlements

It has been brought to the attention of the subcommittee that many taxpayers bypass the administrative machinery of the Appellate Division which was established to give a taxpayer every opportunity to arbitrate his issues short of going to court. Of the total cases disposed of by the Appellate Division in fiscal year 1956 and which had originally bypassed the Appellate Division, only 11.9% were eventually tried in the Tax Court, and 88.1% were disposed of by agreed stipulation, dismissal, or default. Inasmuch as many docketed cases are eventually settled by stipulation in the Appellate Division, the subcommittee feels that serious study should be given by the Commissioner to the reasons why these cases were not settled in the predocketed stage.

In the opinion of the subcommittee, the chief counsel's representative in the field should have the authority after consultation with the Appellate Division to make final settlements with respect to docketed cases since he is responsible for trying cases in the Tax Court. The subcommittee also believes that stipulations should be entered into as promptly as possible after cases are docketed in the Tax Court.

We are concerned that there has been an increase in the inventory of cases in the Appellate Division. For example, with respect to nondocketed cases, there were 9,111 cases pending at the end of fiscal 1955. By the end of fiscal 1956, the number of nondocketed cases had increased to 9,839. Docketed cases show the same trend; at the end of fiscal 1955, 7,961 cases were pending in the Appellate Division. At the end of fiscal 1956, the number pending had risen to 8,422. Thus, in the span of a single fiscal year, the inventory of cases, docketed and nondocketed, in the Appellate Division increased by 1,189. During the same period the number of cases closed declined 1,764, although the number of cases received by the Appellate Division in fiscal 1956 exceeded by 3,398 the number received in the preceding fiscal year.

These statistics are directly reflected

What "Reviewed By The Court" Means

YOU'VE NOTICED those four words at the end of a Tax Court opinion and probably didn't pay too much attention to them. Judge Murdock explained their meaning to the House Subcommittee on Appropriations recently. He said:

"The judge who heard the case renders an opinion. He is required to make findings of fact if they are not stipulated, and file a written opinion.

"That opinion then is reviewed by the Chief Judge. Each opinion is reviewed by the Chief Judge and if approved by him is then published, and that is the end of it.

There is just this little more to that story: If the Chief Judge or the judge who wrote this opinion feels that it is a matter which, for any reason, might well be reviewed by the full court, the Chief Judge can direct its review by the full court. New issues or novel propositions or cases that present considerable difficulty are reviewed by the full court in that way and, after they have been reviewed, they become the decision of the court. ☆

in the case load of the Tax Court. For example cases filed in the Tax Court in fiscal 1955, 3,178 had been considered by the Appellate Division and 1,461 cases bypassed the administrative machinery of the Appellate Division. In 1956, the number of cases bypassing the Appellate Division had increased to 2,526, about a 73% increase. In fiscal 1956, only 2,476 out of 5,002 petitions were considered in the Appellate Division.

From these statistics, it seems clear that the Appellate Division is being bypassed by an increasing number of taxpayers. There appears to be a reluctance on the part of many taxpayers to employ the administrative machinery set up to enable them to settle their differences with the Government without the necessity of litigation. The Commissioner should study this problem and make a report thereon to the subcommittee.

Voluntary disclosures

A study of the desirability of reinstating a policy of voluntary disclosures should be made by the Commissioner with a view toward devising a workable plan which will adequately protect the interests of both the taxpayer and the Government.

The subcommittee has not sufficent facts available to consider the practicability of such a plan. It appears from the many suggestions that have been made that this matter should be considered both from the standpoint of the revenue to be gained as well as from the standpoint of its effect upon the voluntary system of self-assessment.

Jeopardy assessments

Authority to levy a jeopardy assessment is at present delegated to the field by the Commissioner. It is the opinion of your subcommittee that such a powerful legal device should be retained by the Commissioner and authorized only by him. The attention of the subcommittee has been called to the fact that jeopardy assessments have often been used as a means of obtaining from the taxpayer an agreement to waive the statute of limitation. In addition, complaints have come to the subcommittee which indicate that this device has been exercised in the field promiscuously, arbitrarily, or capriciously. Your subcommittee feels that provision should be made for controling jeopardy assessments so as to avoid its use except in cases where the Commissioner believes there is real financial jeopardy. The Commissioner can always extend the statute of limitation by the use of a 90-day letter in those cases where he may have concluded that this is necessary.

It is recognized that, in some cases, the Commissioner should have more time than is presently provided by the 3-year statute in which to develop all details necessary to decide a particular case. Therefore, the Commissioner should study this problem and make a report to the subcommittee.

Criminal prosecutions

We are aware of situations in which agents have made reckless and inexpert overstatements of a taxpayer's liability, in order to justify fraud charges and prevent the running of the statute of limitations, or have brought fraud charges where no return was filed, despite the fact that no tax was due. Such occurrences cause unwarranted public embarrassment to taxpayers and the Service and should be avoided.

Criminal cases are presently referred directly to the Department of Justice from the nine regional offices in the field. The subcommittee feels consideration should be given to a return to the procedure in effect prior to January 8, 1952, whereby all recommendations for criminal prosecution were reviewed in the national office and a uniform policy applied before the case was referred to the Criminal Section of the Tax Division of the Department of Justice for prosecution.

If this is done, consideration might be given to eliminating some of the reviews in the field. One thorough review by a group experienced in this work would appear to be preferable to several reviews at various field levels. A decision as to whether a taxpayer should be prosecuted for fraud should be made only after careful consideration of all the facts and circumstances of the particular case and its effect upon the community as a whole. In no case should a fraud case be instituted unless there is sufficient evidence to warrant a conviction.

Acquiescence in Tax Court decisions

The subcommittee is perturbed about the number of Tax Court decisions in which the Commissioner refuses either to acquiesce or appeal. The initial record in a Tax Court case is made by the Commissioner, and presumably represents the situation most favorable to the Commissioner in his interpretation of the law. When the Tax Court decides in favor of the taxpayer, the Commissioner should follow the decision or appeal it. This policy of neither acquiescing in nor appealing a decision leads to confusion, uncertainty, and lack of uniformity. The Commissioner should reappraise the present procedure with a view toward adopting a policy of appealing or acquiescing in adverse decisions, or requesting the Congress for clarifying legislation.

Policy in the Federal courts

The subcommittee believes a group comprised of representatives of the Department of Justice, the General Counsel of the Treasury and the Commissioner should be established to review tax-litigation policies with a view toward providing greater cooperation among them. Uniform policies would go far toward eliminating needless litigation. If such a group existed with authority to review policies relating to both civil and criminal offenses and to make recommendation, application of the tax law would become more certain and litigation more predictable.

Adverse circuit court decisions

Cases which involve conflicts between the courts and the Commissioner as to

Advisory Group

MEMBERSHIP of the Advisory Group appointed by Mr. Mills consists of the following well known tax practitioners:

Eugene F. Bogan, Chairman
Mark E. Richardson, Vice Chairman
John H. Alexander
Michael D. Bachrach
Bernard H. Barnett
Kenneth W. Bergen
J. P. Goedert
James D. Head
Allan H. W. Higgins
J. Paul Jackson
J. B. Jarratt
Harry K. Mansfield
Robert N. Miller
Leslie Mills
Seymour Mintz
George E. Neal
C. Rudolf Peterson
James K. Polk
H. H. Scaff
Troy G. Thurston
Charles N. Whitehead
Laurens Williams

the proper interpretation of the law are of concern to the subcommittee. We feel that when this conflict advances to the point at which two or more courts of appeal decide a given issue adverse to the Commissioner's position, he should abandon further litigation and seek legislative clarification of the statute involved. The interests of both the Government and the taxpayer are served when needless litigation is avoided, and this is especially true where the court decisions create confusion as to the proper interpretation of the law.

At present, only a person who meets certain qualifications can obtain a Treasury card entitling him to represent a taxpayer before the Treasury Department.

In small towns, taxpayers often rely upon such experienced accountants, to assist them in preparing their tax returns. Many cases could be disposed of at the revenue agent or group chief level if these persons were permitted to represent the taxpayer at informal hearings. ☆

New procedural decisions this month

Withholding agents not real party in interest; claim rejected. Taxpayer withheld tax from payments to its nonresident alien shareholders and brought this suit for refund. It is rejected because taxpayer was not the real party in interest. The shareholders' individual claims, which were presented too late, cannot be considered an amendment of the corporation claim. *Higgins Estate,* DC Cal., 2/28/57.

Court assumes taxpayer got extension to file; that makes assessment timely. This suit against taxpayer's widow is timely if the assessment was made within three years of filing. The court notes that the burden of proving the assessment barred is on the taxpayer. It accepts the presumption that the return itself (for 1944) was timely filed (by March 15, 1945). However, since extensions up to six months may be granted, the court states the presumption is that the return was filed by September 15, 1945, and an assessment on March 17, 1948 is within three years of filing and timely. *Skolnick,* DC, N. Y., 3/15/47.

Denial of injunction against collection proper; could have filed bond. The district court denied taxpayer's request for an injunction against collection of a jeopardy assessment. This court affirms. Financial hardship of the taxpayer is not a circumstance justifying an extraordinary remedy. Whether his financial difficulties will prevent his hiring legal and accounting help and make a fair trial impossible can be determined only after trial. Moreover, the taxpayer could have stayed collection by filing a bond. *Lloyd,* CA-5, 4/3/57.

Didn't appeal some years; after victory, can't relitigate them. Taxpayer paid part of additional assessments for 1943-46, and brought suits for all years. At issue was the validity of a family partnership. The district court's decision was against taxpayer. He appealed all years, except 1945, and won. Taxpayer then paid the rest of the 1945 assessment and sued for its refund. The court holds that the year 1945 had once been litigated, and no appeal having been taken, the doctrine of res judicata prevents a collateral attack on the prior judgment. *Snyder,* DC Cal., 3/22/57.

Life insurance beneficiary transferee for cash surrender value only. Decedent carried policies on his life which named his wife as beneficiary. He was solvent when policies were issued and when premiums were paid, but was insolvent at death. The widow received somewhat in excess of $63,000 as the proceeds of the policies, although the cash surrender value at the time of death was only $3,300. The district court held she was liable for some $11,000 unpaid income tax of her husband. This court limits the recovery to the cash surrender value. The court recognizes contrary conclusions in the Second Circuit in *Rowen* (215 F2d 641) and in the Sixth Circuit in *Tyson* (212 F2d 16). In these cases the widow was held not liable as a transferee. This court, however, holds that the cash surrender value was a property right of the decendent transferred to the widow. *Bess,* CA-3, 3/28/57.

Tax lien on policy extends to cash surrender value. The district court held that the cash surrender value of decedent's policy merged into the proceeds at death and that the property interest which supported the liens disappeared at death. Accordingly, decedent had no interest in the policy which survived him, and the proceeds were not subject to lien for his taxes. This court reverses, upholding the lien to the extent of the cash surrender value. The government lien against the cash surrender value was obtained prior to death and this asset cannot be transferred gratuitously after the lien has been attached. *Harper,* CA-7, 3/20/57.

Life-insurance beneficiaries liable as transferees to extent of full proceeds. Beneficiaries of a life-insurance policy are held liable as transferees for the decedent's unpaid income taxes to the extent of the proceeds. The decedent retained until his death the right to change the beneficiaries. The Tax Court refuses to follow the reasoning of the Second Circuit in the *Rowen* case that the proceeds were not ever, in any sense, the property of the deceased taxpayer and hence not transferred by them. *Stoumen,* 27 TC No. 125.

Amended answer deemed admitted on failure to reply. The Commissioner had requested an additional assessment by filing an amendment to his answer. As taxpayer failed to file a reply, the allegations of the amended answer are held to be admitted. At the trial, taxpayer failed to show that his income was any less than the amount determined, or that he was entitled to any greater deductions than the Commissioner had used in computing the deficiencies. *Lugauskas,* TCM 1957-56.

No double penalty for nonfiling of estimate under 1939 Code. Taxpayer did not file a 1951 estimate. Two penalties were imposed: the 10% penalty for failure to file and the 6% penalty for substantial underestimation. Agreeing with district court decisions in Georgia, Nebraska and Arizona, this court holds the further imposition of the 6% penalty improper. [The Service has announced it will not follow these cases. Under the 1954 Code only one penalty is applicable. *Ed.*] *Stenzel,* DC Cal., 3/22/57.

Procedures for renewal of enrollments to practice. The Service sets out its prescribed procedures in Circular 230 for the renewal of enrollments to practice before the Treasury Department. All practitioners desiring to continue to be qualified to practice before the Treasury are required to comply with the stated procedures in order to obtain Treasury cards. *Rev. Proc.* 57-3.

TAXATION OF

Partnerships

EDITED BY JACKSON L. BOUGHNER, LL.B., CPA

How partners can avoid tax traps through proper drafting of partnership agreement

by **JOSEPH RABIN**

The 1954 Code is full of tax rules applicable "unless the partnership agreement provides otherwise". Clearly, this places tax control squarely on the organizers of the firm. Mr. Rabin analyzes the 13 most common situations that are controlled, taxwise, by the agreement, and advises how to get the most advantageous tax treatment.

THE PARTNERSHIP provisions of the 1954 Code appear to have been clasped to the bosom of the tax practitioner with comments ranging from enthusiastic approval to a more modest appraisal exemplified by statements that the provisions are "moderately complicated" and will require considerable study. Some writers even caution the practitioner not to abandon a project of planned study of the provisions because of any initial feeling of confusion. Certain it is that many lawyers and accountants will be surprised at the tax results under the 1954 Code of some of the standard provisions in the usual partnership agreement.

The tax complications involved in drafting a partnership agreement under the present Code make it imperative to utilize the abilities of the lawyer and the accountant functioning as a "team" to serve the needs of the client adequately.

It is the purpose and scope of this article to discuss some of these tax traps and to offer a checklist to aid the lawyer-accountant team in the preparation and tax-planning of a business partnership agreement.

Basis of Contributed Property

Assume that partner A is to contribute $20,000 in cash and partner B is to contribute machinery and equipment valued by the parties at $20,000. A and B are to share equally in profits and losses. Further assume that B had paid $40,000 for this machinery and equipment, but had depreciated it to the point that there remained only $1,000 of adjusted basis to B.

Section 723 states that the basis of property contributed to a partnership by a partner shall be the adjusted basis of such property to the contributing partner at the time of the contribution.

If the partnership agreement is silent on the subject, Section 704(C) provides a general rule for determining a partner's distributive share of depreciation or gain or loss on property contributed to the partnership. It provides that depreciation and the gain or loss shall be treated as though they arose on property purchased by the partnership.

Sale of contributed property

Assume that shortly after the formation of the partnership, the partners decide that new machinery and equipment are needed; they sell the old machinery and equipment for its market value of $20,000. Under Sections 723 and 704, the basis of the machinery and equipment to the partnership is $1,000. There is no provision in the partnership agreement with respect to the special allocation of gain on contributed property. Therefore, the $19,000 "gain" is treated as if it were a gain on property that had been purchased by the partnership and subsequently sold, and *each partner's distributive share of such gain is $9,500!* A, who invested only cash, will be taxed on a highly fictitious profit.

Suppose the machinery and equipment are retained by the partnership and that the contributed property depreciates at an annual rate of 5%. Partner A anticipates that the partnership has an annual expense deduction of $1,000 (5% of $20,000) and, that if the partnership earns $1,000 before depreciation there would be no taxable income.

But because the basis to the partnership of the machinery and equipment is $1,000, the partnership has a depreciation deduction of only $50 and a taxable net income of $950. Since the partners are sharing profits equally, this results in taxable income to A of $475 and the same to B!

This inequitable result could have been avoided if in lieu of having the general rule apply, the partnership agreement allocated solely to the contributing partner the tax consequences of the difference between his cost (or adjusted basis) for the property, and the value at which it was contributed to the partnership.

How to handle losses

Continuing with this same situation, let us look at some other sections of the 1954 Code. Section 722 states that the basis of an interest in a partnership acquired by a contribution of property shall be the adjusted basis of such property to the contributing partner at the time of the contribution. Section 704(D) provides that a partner's distributive share of partnership loss shall be allowed only to the extent of the adjusted basis of such partner's interest in the partnership at the end of the partnership year in which such loss occurred. Any excess of such loss over such basis shall be allowed as a deduction at the end of the partnership year in which such excess is repaid to the partnership.

Let us assume that the A-B partnership at the end of the first taxable year has a loss of $20,000. In accordance with the above sections, partner B's interest in the partnership is $1,000, not $20,000 (market value of machinery and equipment). Therefore, B's distributive share of partnership loss allowed to him is only $1,000. B may not deduct the

$9,000 difference in the first taxable year. He will have to wait until the partnership has realized enough income so that his partnership interest has increased sufficiently to utilize this $9,000 loss "carryforward."

This result is hardly one which will be appreciated by B, particularly in light of the explicit statement in Section 704 that a partner's distributive share of loss shall, except as otherwise provided in the section, *be determined by the partnership agreement.*

Distributions

Proceeding further, let us look at Section 731. This section provides that in the case of a distribution by a partnership to a partner, gain shall not be recognized to such partner, except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution. Applying this section together with Section 722 to our situation, let us suppose that B draws $5,000 in the first year of the operation of the partnership, despite the fact that in the first year of operation the partnership does not realize any profit.

Since Section 731, as interpreted by the Regulations, applies to current distributions as well as to distributions in liquidation of a partner's entire interest[1] B has realized gain to the extent of $4,000 ($5,000 in drawings less $1,000 adjusted basis of his contributed machinery and equipment). Partner B thus has to pay tax on $4,000 of "income," despite the fact that the partnership has not realized any profit from operations for the year.

Encumbered contributed property

Let us go on to a slightly different situation in which A and B intend to form a partnership for the ownership and rental of income-producing properties. To this end A contributes $20,000 in cash and B contributes a building with a cost to him of $4,000 and a market value of $30,000, encumbered by a $10,000 mortgage.

Section 752(b) provides that if a partnership assumes the personal liabilities of a partner (or a liability to which property owned by the partner is subject), the amount of the decrease in the partner's liabilities is treated as a distribution of money to him by the partnership within the meaning of Section 731. This section and the Regulations thereunder[2] further provide that where property subject to a liability is contributed to a partnership or distributed by a partnership, the amount of the liability shall, to an extent not exceeding the fair market value of the property, be considered as a liability assumed by the transferee.

Applying the Code and Regulations to our factual situation, we find that B has received a taxable gain of $1,000! The reasoning is that when B contributed the building with the basis of $4,000 to the partnership, the basis of B's partnership interest becomes $4,000 reduced by $5,000 (one-half of the mortgage of $10,000 is now attributable to A) and, as was noted above, the excess is treated as distribution of money to B.

Interest of retiring or deceased partner

Suppose A and B enter into a partnership for manufacturing purposes, each having initially contributed $20,000 in cash. After a number of years of successful operation, B decides to leave and A agrees to buy his interest for its book value plus $20,000. Both A and B realize that this excess payment is in reality the price that A is willing to pay for the going value or goodwill of the business. What is the tax status of this excess payment under the 1954 Code?

Under Section 736 of the Code, the tax status of the excess payment is determined almost entirely by the provisions of the partnership agreement. If the partnership agreement specifically provides that any excess payments are made for the partner's interest in goodwill, such payments will be a capital transaction to the retiring (or deceased) partner and taxable gain would be *capital gain.*

Partner B might be satisfied with this result since his savings would be substantial. But A might be very unhappy since there would be no corresponding deduction to him for the $20,000. Moreover, if the agreement is silent, then the payments to the retiring partner will *not* be considered as having been made for goodwill and instead will be ordinary income to the retiring partner and deductible (if correctly handled) by the purchasing partner. It may very well be that the purchasing or continuing partner is in a substantially higher tax bracket and that the partnership would prefer to arrange the payments so that they will be a share of partnership income or a guaranteed payment. So long as such payments reduce the taxable income of the continuing partner, he can afford to be more generous to the retiring or deceased partner than would be possible if the payments were made with "after-tax" dollars.

The important point, however, is that Section 736 affords a striking example of the significance of planned provisions in a partnership agreement under the scheme of the 1954 Code. The partners are permitted to work out in advance, to their own possible advantage, the income tax consequences of such payments!

Sale of a partnership interest

Suppose the A-B manufacturing partnership is fairly successful, and after a year or two C wishes to buy an interest in the partnership.

Prior to the entry of C into the partnership, the partnership assets consist of cash of $10,000, inventory of $10,000, and depreciable assets of $10,000, for a total of $30,000. A has a basis for his partnership interest of $15,000 and B has a basis for his partnership interest of $15,000. A and B are willing to sell C a one-third interest in the partnership for a payment made personally to A of $10,000 and a like sum paid to B.

Thus, the partnership assets consist of the same $30,000, but the capital interests of the three partners are now $10,000 each. However, C has paid $20,000 for this $10,000 interest. If the excess payment by C is for appreciated market value of the inventory and depreciable assets, then unless affirmative action is taken by the partnership at the outset, the excess payment by C will not be recoverable during the life of the partnership!

To avoid this result, Sections 734 and 743 of the 1954 Code provide for optional adjustments to the basis of the partnership property and interests. The rule is stated in the negative by Section 743. It provides that the basis of partnership property shall *not* be adjusted as the result of a transfer of an interest in the partnership, unless the election provided by Section 754 is in effect with respect to the partnership. If the partnership has filed this election, the basis

[*Mr. Rabin, an attorney and certified public accountant in Beverly Hills, California, has written widely on taxes. Another article based on the same material written by the author recently appeared in "The Practical Lawyer."*]

[1] Reg. Sec. 1.731(a)(1)(i). 731-1(a)(1)(i).
[2] Reg. Sec. 1.752-1(a)(2)(G)(2).

of the partnership property is increased to the extent of the $10,000 paid by C which represent C's share of the appreciation of partnership inventory and depreciable assets not reflected on the books of the partnership.

It should be noted that this is a *partnership* election and, therefore, to protect C's interest in this partnership, the agreement covering his admission might provide for such an election increasing basis at the option of C, the new partner.

Death of a partner

When a calendar or fiscal year for the partnership was originally chosen, little thought may have been given to its effect on tax treatment of a sale or the death of A or B. But several problems do arise.

Section 706 provides that a newly formed partnership which wishes to adopt a taxable year that is different from the taxable year of any of its principal partners must secure prior approval from the Commissioner, except that a new partnership may adopt a calendar year without securing prior approval even if all of the principal partners do not have the same taxable year. A and B intend to go into the manufacturing business, and, from the standpoint of a "natural" year ending and a postponement of first year taxes, A and B would like to adopt a taxable year ending March 31st. The partnership agreement, by the judicious use of terminology, may effect some substantial tax savings in the event of a sale of a partnership interest or the death of one of the partners.

The result to be avoided is the bunching of income in the year of sale or death of one of the partners. For example, assume B sells his partnership interest to A on December 1st, or B dies December 1st, and B's executor effectuates a sale to A of B's interest prior to December 31st. Section 708 provides that a partnership is terminated if (1) no part of any business or venture of the partnership continues or (2) within a 12-month period there is a sale or exchange of 50% or more of the total interest in partnership capital and profits.

Furthermore, Section 708 provides that upon the death of one partner in a two-member partnership, the partnership shall not be considered as terminated if the estate continues to share in the profits or losses of the partnership business. However, if the estate sells the partnership interest, then of course, the estate does not continue as a member of the partnership.

Thus, in our A-B partnership, unless the partnership agreement provides for this contingency, each partner will report in one calendar reporting period his distributive share of the partnership income for the 21 month period beginning April 1st of one year, and ending November 30th or December 31st of the succeeding year.

Questions that must be asked

Of course, other tax traps lurk within the 1954 partnerships sections. Some of them are the collapsible partnership, negative basis property, distributions to partners in the form of property, etc. However, the scope of this article is limited to directing the attention of the lawyer and accountant to the more important and common tax problems relative to the partnership agreement. Thus, the lawyer-accountant team should be prepared to ask the following questions of their client.

1. What property is being contributed by the partners?

2. What did the partners pay for the property?

3. Has the property been depreciated? If so, what is the adjusted basis of the property at the present time?

4. Is the property encumbered? If so, in what amount?

5. How is depreciation to be allocated in respect to contributed property?

6. How is gain or loss in respect to specific properties to be allocated?

7. In the event of low basis capital interest, would a provision treating drawings in excess of capital as a loan repayable by the withdrawing partner be acceptable to the partners?

8. In the event of loss, would a provision requiring the partners to make a contribution to cover the loss in excess of capital interest be acceptable to the partners to enable them to obtain the loss deduction?

9. Are there any provisions for guaranteed payments to the partners and, if so, do the partners intend and realize that these payments may be includible in the recipient's return for the taxable year as if they had been made to an outsider, when the payments are not dependent upon partnership income? In the event of a termination of a fiscal-year partnership, would a clause be warranted to prevent termination of the fiscal year either by sale or death?

10. In respect to payments to a retiring partner or a deceased partner's estate, do the parties realize the significance of a statement regarding goodwill in the partnership agreement and the tax effect both to the continuing partner and to the estate of the retiring partner or to the selling partner? In the event of a buy-and-sell agreement between the partners, do the partners realize the tax effect to both the deceased partner and the remaining partner?

11. In the event of a liquidation of the partnership and a pro-rata distribution of partnership assets, do the partners realize the distinction between a pro-rata distribution of accounts receivable and inventory, as opposed to capital items (ordinary income v. capital gain)?

12. In the event of purchase of a partner's interest or admission of a new partner, what price is being paid by the new partner for his interest and how does it compare with the book values on the partnership books? Would a provision requiring compulsory election under Section 754 be agreeable to all the parties?

13. In the event of a contribution of services by the contributing partner in return for his capital interest, does the contributing partner realize that he may have taxable income, under the Regulations interpreting Section 721? See Treas. Reg. Section 1-721-1(b)(1).

These are some of the problems that the lawyer and the accountant should discuss with their client prior to the drafting of the partnership agreement. No doubt, other provisions will suggest themselves to this professional team. ☆

New partnership decisions this month

Lawyer has ordinary income for uncollected fees on sale of partnership interest (old law). Taxpayer sold his 50% interest in his law partnership when it had accounts receivable of about $20,000. The Commissioner taxed $10,000 of the price of the interest as ordinary income. The court agrees. The fact that the partnership was on a cash basis is not significant; the rules for determin-

ing the partners' share of partnership income apply only while he is a partner. The court refuses to follow the rule of *Sivirin* (183 F2d 656, cert. den., 340 U.S. 912) in which the Seventh Circuit held that the entire proceeds of sale of an attorney's partnership was capital though there were large receivables outstanding and unbilled earned fees. [The 1954 Code provides specific rules for treating proceeds of sale as ordinary income to the extent that they represent unrealized receivables. *Ed.*] *Tunnell,* DC Del., 2/4/57.

Employees S & L association not taxable as a corporation. This court reverses the holding by the district court that the association was taxable as a corporation. It finds there is no substantial economic independence of the association from its members; this is more like an agency through which a group of individuals in a joint enterprise can make a temporary, diversified investment. The court points out that membership units of $50 were not transferable and could be redeemed at any time, that there was no limited liability feature, and that earnings were paid out annually. The only resemblances to a corporation were: centralized management and the ownership of property as an entity. *Guarantee Employees Association,* CA-5, 1/18/57.

Partners sharing different items in different ratio okay under 1939 Code. In *Rev. Rul.* 56-134 the Service held that for tax purposes it would regard as two partnerships a firm doing business in both the United States and a foreign country and dividing profits from domestic and foreign branches among partners in different ratios. The ruling applied to the years before 1954. The Service now revokes that ruling. The 1954 Code specifically permits partners to allocate different items of income and expense differently so long as tax avoidance is not the motive and the Senate Committee report said this provision is in accord with practice under the 1939 Code. *Rev. Rul.* 57-138.

Trusts were bona fide partners. Taxpayers each owned a one-sixth interest in a partnership manufacturing clothing. Neither rendered services to the partnership. Each created trusts for the benefit of members of their families, and transferred $52,000 to the trusts from their capital accounts. A new partnership agreement recognized the trusts as limited partners. The court finds that the gifts were absolute and the trusts were partners. The control over the business by taxpayers is not significant since limited partners have no part in the control or management of the partnership business. *Dickstein,* DC Pa., 3/20/57.

FAMILY PARTNERSHIPS

Wives are partners though they contributed neither capital nor services. Taxpayers, who were brothers, and a sister conducted a partnership which manufactured sportswear. The sister's husband, a valuable employee of the firm, requested that he be made a partner. In order to accommodate him and retain an equal voice for each family, a new partnership was formed composed of taxpayers and their sister as general partners, and of their respective spouses as limited partners. Each general partner assigned part of his or her capital account to the spouse as a limited partner. In a prior proceeding involving 1941-1943 (prior to the Supreme Court decision in the *Culbertson* case) the court held the wives were not to be treated as partners. For the years in issue, 1946 and 1947, the court now rules, following *Culbertson,* that the spouses were bona fide limited partners even though they contributed neither capital nor services. The test now is whether they intended to join together as partners to carry on the business. Services and capital are merely evidence of the intent and here the intent is clear. *Fainblatt,* 27 TC No. 121.

Wife not real partner; no capital and no service. Taxpayer and three brothers took their wives into their business as partners. The court finds the partnership invalid for tax purposes; there was no real purpose to have taxpayer's wife join the business. Her capital came from a bank loan guaranteed by taxpayer (repaid out of profits) and gifts from the taxpayer. Her powers were restricted by the partnership agreement, and she performed no services. *Sheerr,* DC Pa., 1/31/57.

Jury finds husband and wife partnership valid; fiscal year proper. Taxpayers, husband and wife, formed a partnership in July 1952. The capital was community property. The Government argued that this was not a bona fide partnership and that taxpayers must report the business income on their own calendar year, not on the basis of a partnership fiscal year ended January 31. The court charged the jury to consider the intent of the parties and the capital and services contributed. The jury finds the partnership was formed for business purposes. *Morales,* DC Tex., 1/12/57.

Can't repudiate family partnership. The Commissioner attempted to disallow a family partnership. The taxpayers, wife and two sons, protested. Suddenly, for an undisclosed reason, the two sides reversed their positions. The district court held that taxpayers may not contend that they were not really partners, despite the fact that they: (1) were, respectively, a housewife and two soldiers, (2) obtained their interests by gift, (3) did not actively participate, and (4) contributed nothing to the partnership. They intended to have a partnership and may not introduce the kind of evidence the Government uses in family-partnership cases to show otherwise. This court affrms. *Sherman,* CA-3, 2/12/57.

Jury holds wife wasn't a partner. Taxpayer contended that his wife was a limited partner and her share of the profit should not be taxed to him. The court instructed the jury to determine whether his gift of capital to her was bona fide, and then, if it was, whether the partnership itself was bona fide. It said that the parties must have joined in the conduct of the business in good faith and with a business purpose, and that in determining the intent of the parties the jury must consider the capital contributed, the need for the capital and the return on the capital. The jury held the wife was not a partner for tax purposes. *Rose,* DC N. Y., 11/30/56.

Jury finds wives weren't partners. The court charged the jury to consider whether the agreement was made in good faith, whether the wives contributed capital or substantial services. Taxpayers had the burden of proving the validity of the partnership. The partnership agreement provided that the votes of the two husbands in favor of any agreement would constitute a majority. The court finds that the partnership was invalid for tax purposes. *Carlson,* DC Minn., 10/29/56.

NEW DEVELOPMENTS IN TAX ASPECTS OF

Accounting

EDITED BY CARL M. ESENOFF, CPA, & C. W. LAMDEN, Ph.D., CPA

Choosing the most practical method for depreciating long-lived assets

INDUSTRIES WITH long-lived assets, such as utilities, have special depreciation problems; and if the industry is a growing one, there are special considerations involved in choosing among the several permitted new methods. Utilities have the additional problem of dealing with the attitudes of regulatory commissions. All these problems, with special emphasis on the utilities industry, were recently discussed by John L. Harvey, CPA, of the Pittsburgh office of Arthur Young and Company. Summarizing the consensus of experts in the utilities industry, he said:

The most significant aspect of liberalized depreciation and the resulting current tax reduction is the effect these will have on rates which regulatory commissions permit utilities to charge for their product. Such rates are designed to permit the company to earn a return on the investment of its stockholders comparable to that earned by investors in private industry for comparable risks. This involves a determination of earnings and of investment. Both depreciation and income tax expense (Federal and state) affect earnings while accumulated depreciation affects investment.

Generally speaking, tangible depreciable property represents a very large proportion of the total assets of a public utility company. Furthermore, annual expenditures for fixed assets are usually large and are significantly greater than retirements. This results not only from the expansion of service required by an expanding economy but because replacements are made at costs greatly in excess of the costs of the assets being retired because of the great reduction in the buying power of the dollar during the long lives of assets now being replaced.

A continued increase in the dollar value of the depreciable assets has the effect of postponing indefinitely the time when the annual depreciation calculated under one of the liberalized methods drops below the annual depreciation calculated under the straight-line method. This means that the tax deferral inherent in liberalized depreciation is moved so far into the future, perhaps to a point beyond the life of the company as a profitable enterprise, that the use of such depreciation results in a permanent tax-savings rather than merely a deferral. Such savings could, of course, be upset by a revision of the Internal Revenue Code. It must be recognized, however, that the tax effect of adopting liberalized depreciation must be calculated on acquisitions of individual years, and with respect to any one year's additions there is a deferral of tax for a limited period only. A series of annual additions must be put together to achieve a permanent tax savings.

Methods of determining earnings

Consider, first, the alternatives available in the determination of earnings. With respect to depreciation expense the regulatory commission could use the amount determined by applying a liberalized method or the amount determined by a straight-line method. The tax expense might be either the actual tax paid (based on liberalized depreciation) or a "normalized" tax, i.e., the tax paid plus the tax "deferred" through the use of accelerated depreciation. In theory any combination of these could be used, i.e.: (1) Straight-line depreciation and actual tax; (2) Straight line depreciation and "normalized" tax; (3) Liberalized depreciation and actual tax; (4) Liberalized depreciation and "normalized" tax.

In practice, however, combination (4) would have so little theoretical justification and would so depress income that commissions would be very unlikely to consider it as a serious possibility.

The use of straight-line depreciation and actual tax (based on liberalized depreciation) would result in increased income for rate purposes which would necessitate a reduction in rates. Under this combination the stockholders' only benefit will be from the usual delay which occurs in the revision of rates.

The use of straight-line depreciation and "normalized" tax would, of course, produce the same income as though no change in tax depreciation had been made. There would be no revision of rates. As discussed more fully below, the difference between "normalized" income taxes and actual income taxes might be set aside as a reserve for deferred income taxes in anticipation of a time when straight-line depreciation was greater than liberalized depreciation and actual taxes greater than "normalized" taxes. If that time never came, the regulatory commissions would have to prescribe the disposition of the unused reserve. Alternatively, the tax-savings might be passed on currently to stockholders, although there appears to be very little possibility of commissions permitting book accounting to vary with rate accounting in this regard.

Under combination (3) the increase in depreciation expense would more than offset the decrease in income tax expense and the commissions would have to allow increased rates.

Rulings by state utility commissions

At the present time many commissions have taken no stand on liberalized depreciation, and the position of those who have issued orders is not uniform. A number of states have issued rulings with respect to the accounting for liberalized depreciation, but generally these are not binding for rate-determination purposes. The underlying philosophy seems to be, however, that the adoption of liberalized depreciation should not affect rates. In other words they favor the use of straight-line depreciation and "normalized" tax (combination (2)). The orders for the most part require that the difference between "normalized" and actual tax be credited to a reserve for deferred taxes or a restricted surplus account.

One notable exception is the position taken by the Pennsylvania Public Utility Commission in several rate orders issued in 1955 and 1956. In these orders the Commission takes the position that the tax reduction is permanent in nature

and not simply a deferral of tax. The Commission, therefore, adopts combination (1), allowing straight-line depreciation and actual tax. One of these rate orders is being appealed to the Superior Court.

The Federal Power Commission, ruling on a recent petition of The Columbia Gas System, Inc., has permitted the use of "normalized" tax with straight-line depreciation. Although this was an accounting ruling, it is reasonable to assume that the same approach would be taken by the FPC in the determination of rates.

No regulatory body has suggested or acted upon a petition suggesting the use of liberalized depreciation and actual tax for rate-making purposes (combination (3)).

Power Commissions haven't ruled

Neither the FPC nor the state commissions (except Wisconsin) has been asked to rule on whether straight-line or liberalized depreciation will be used in determining the value of the plant for rate-base determination. Alternatively, should utility companies be entitled to earn a return on the plant which may be acquired with funds derived through deferred taxes? In certain states where the so-called "fair value" method is used in determining rate base, depreciation is computed by an engineering estimate and would not be affected by the adoption of liberalized depreciation.

The Wisconsin Public Service Commission has attempted to effect a compromise by allowing the excess of "normalized" tax over actual tax as additional depreciation and reducing the rate base by this amount. This has the effect of reducing rates to benefit the consumer and of allowing the company to retain at least part of the funds generated by the reduction in current taxes.

Depreciation and taxes per books

As already indicated, the matter of rate regulation is closely allied to the regulation of public-utility accounting by state and Federal commissions. The first question is whether or not liberalized depreciation should be reflected on the books of account. Almost without exception public utility companies are anxious to avoid recording liberalized depreciation on their books. Although recording liberalized depreciation might encourage commissions to consider the higher annual depreciation expense for rate purposes, it would also encourage the commission to reduce rate bases by the greater accumulated depreciation. Perhaps the greatest deterrent to the booking of higher annual depreciation is the realization that, unless such depreciation were allowed for rate purposes, there would be an undesirable decrease in reported net income. To date no regulatory body has ordered liberalized depreciation to be recorded on the books as a prerequisite to claiming such depreciation for tax purposes.

Assuming that liberalized depreciation will be employed only on tax returns, the remaining accounting problem relates to the account to be credited for the excess of "normalized" income tax over that actually paid. If the tax reduction is considered in the nature of a deferral, then the proper accounting would seem to be to credit a deferred-expense account which would be carried on the liability side of the balance sheet. Commissions advocating this accounting have titled such an account "Reserve for Deferred Federal Income Tax." A slightly different but fundamentally similar treatment has been adopted by other state commissions. This requires that the credit be made to a surplus account entitled "Earned Surplus Restricted for Future Federal Income Taxes." To date, only the Pennsylvania Public Utility Commission appears to favor recognizing the tax-savings as current income. This position is indicated in a rate order. No accounting order has as yet been issued in that state.

Credit to reserve not good

A final possibility would be to take the credit to the depreciation reserve. Despite the position taken by the Wisconsin Commission, it is generally felt that this is an inferior alternative.

Since liberalized depreciation methods became effective January 1, 1954 and final elections relating to their adoption were not required for tax purposes until September 15, 1956, companies have reported income for several years without knowing whether the accounting was in accordance with that to be prescribed by the regulatory commissions. This may result in significant accounting adjustments. The most important might be that resulting from a company's recording "normalized" taxes on its books for several years prior to its Regulatory Commission's ruling that only actual taxes are to be recorded as an expense. This would, of course, necessitate a credit to surplus for the difference between "normalized" and actual taxes for the years involved.

If a company which has computed its income tax liability based on straight-line depreciation for 1954 and 1955 and in 1956, elects to adopt liberalized depreciation and is permitted to perform deferred tax accounting, no prior year adjustment is necessary. The only entry would be to reclassify the overaccrual of income tax from the regular accrual account to the "Reserve for Deferred Income Taxes."

Which new depreciation method?

Once a public utility decides to adopt liberalized depreciation, the question of which method to use remains. Although other alternatives are available basically the choice is between the declining-balance method and the remaining-life modification of the sum-of-the-years-digits method. The following points should be considered in evaluating the two methods.

First, it should be recognized that except for the first few years (which is significant only for short-lived assets) depreciation is accumulated more rapidly under the sum-of-the-years-digits method, provided that salvage values are low. This, in turn, means that in those cases where continued asset additions push the deferral of taxes into the distant future, the tax-saving is greater.

Second, as suggested in the preceding paragraph, the amount of salvage must be taken into consideration. Since salvage reduces the annual depreciation calculated under the sum-of-the-years-digits method but not under the declining-balance method, the larger the salvage value the more the declining-balance method improves relative to the sum-of-the-years-digits method. Therefore, if a company uses gross salvage the declining-balance method will be more attractive than in the case of a company using net salvage. For each asset life there is a critical ratio of salvage to cost that determines under which method the more rapid accumulation of depreciation can be obtained.

Third, under the declining-balance method, although no salvage need be estimated initially, at the time of the shift to straight-line depreciation both salvage value and useful life must be negotiated with the Service.

Fourth, the records required under the two methods may differ. An essential aspect of the declining-balance method is the shift at the optimum moment to

straight-line depreciation. This means that property records must be maintained by year of acquisition. Such records may have been established for other purposes, but otherwise an increase in record-keeping cost should be anticipated. There is some indication, however, that regulatory commissions may require such records even when the sum-of-the-years-digits method is used. It should be noted that under the remaining-life plan of the sum-of-the-years-digits method it is necessary to maintain straight-line-depreciation records. Where the utility is using straight-line depreciation for book purposes this, of course, imposes no hardship.

Finally, there is the problem of whether utility property (e.g., gas-well construction) depreciated on a unit-of-production basis should be placed on liberalized depreciation. In the case of gas wells the higher production generally comes in the first years of the well's life and hence the same result is achieved as through the use of liberalized depreciation. Only a detailed study of individual situations can determine whether or not liberalized depreciation is advantageous.

Conclusion

In view of all these considerations it would seem safe to conclude that very few public utility companies would not benefit from the adoption of liberalized depreciation for tax purposes, utilizing that method which would in their particular situation produce the greatest reduction of taxes over the years. If the regulatory commission under which the company operates permits "normalized" tax burdens in the determination of rates, the company will benefit from the interest-free Government "loan" resulting from the deferral of tax. If the reserve for deferred taxes is never used, some future benefit may accrue to stockholders in the form of additional equity. It is interesting to note that Federal Power Commissioner Connole, who wrote a dissenting opinion to the Columbia Gas System order, describes the reserves as "a permanent and involuntary contribution to capital by rate payers."

If the commission permits only actual income taxes for rate purposes, at least the company will benefit through higher earnings until rates are adjusted. In this connection it should be noted that so long as asset additions are made each year in excess of retirements, the annual tax-savings resulting from the use of liberalized depreciation will continue to increase. This means that the lag in rate adjustments will be of continuous benefit to the company.

There are those who question the advisability of management's adopting a policy that may principally benefit the consumer rather than the stockholder. Were this philosophy to prevail, no economies would ever be adopted by the management of public utility companies. If nothing else, the effort of management to reduce taxes should have a favorable reaction upon regulatory commissions. Reducing rates (or more realistically, not increasing rates) will generate customer goodwill, a much sought-after commodity these days, and will put the company in a better competitive position. ☆

Bad-debt reserves: how to obtain the tax advantages of the averaging method

TAX MEN FOR BANKS know the difficult problems in using the special methods allowed for determining bank bad-debt reserves. They'll want to get the September *Banking Law Journal* and read the whole survey by Weston Vernon, Jr., and Howard A. Bolton of the New York law firm of Milbank, Tweed, Hope & Hadley. For the rest of us—non-bankers—here is the essence of it: enough to give you an idea of how the system works. It is an example of an industry receiving special treatment because the general Code provisions were unworkable for this group of taxpayers.

Messrs. Vernon and Bolton begin by pointing out that since 1921, the bad-debt reserves of commercial banks have been governed by the same statutory provisions as those of other taxpayers entitled to use the reserve method. Distinctions have been made since 1947, however, between the treatment of bad-debt reserves of commercial banks and those of other taxpayers through administrative rulings, principally Mimeograph 6209 and Revenue Ruling 54-148. Both of these Rulings recognize, at least implicitly, the difficulties encountered by banks prior to 1947 in the application of the statutory reserve method.

Though there were difficulties, the method had many advantages. It reduced the fluctuations in the amount of a bank's taxable income, since the deduction for the reserve addition in any year is based upon the amount of loans currently outstanding. In addition, the reserve method permits to some extent the matching of bad-debt losses and interest income from loans. This consideration is of special importance to long-term lenders, who may include in gross income substantial amounts of accrued interest from loans which ultimately become uncollectible.

Advantages not realized

In practice, these advantages of the general statutory reserve method have not been realized fully, partly because of the ambiguity of the term "reasonable addition" to a bad-debt reserve and partly because of the discretion vested in the Commissioner to allow, and consequently to disallow, deductions from gross income on account of such additions to the bad-debt reserves. The burden rests upon the taxpayer to show that a disallowance of a reserve addition was an abuse of the Commissioner's discretion. Thus, a taxpayer's "absolute right" to deduct worthless debts apparently vanishes when the reserve method is adopted.

Problems have also arisen from the Commissioner's contentions, in which he has been sustained, that a bad-debt deduction in one year cannot be justified on the ground that similar additions to a bad debt reserve have been uniformly deducted and allowed in prior years, nor upon the ground that other businesses extending credit to similar classes of trade have sustained losses comparable to those sought to be deducted. Moreover, amounts determined by examining agents as "reasonable additions" have often been based upon as little as five years' loss experience, even though that period would seem clearly inadequate in most instances to produce a representative average-loss-experience percentage covering losses of both good and bad years in the economic cycle.

The advantages of the reserve method have also been diminished considerably by the denial of "recovery exclusion" benefits to reserve-method taxpayers. While taxpayers using the specific charge-off method have been entitled to

exclude bad-debt recoveries to the extent that the corresponding bad debts were deducted without tax benefit in prior years, the Treasury has taken the position that this "recovery exclusion" principle is not available to reserve-method taxpayers since their bad debts are not "deducted" when charged to the reserve. The effect upon reserve method taxpayers has been to reduce their annual reserve additions by the amounts of their bad-debt recoveries, since recoveries must be added to reserves and taken into account in determining "reasonable" annual additions. The Treasury's position does not appear to have been contested in litigation, although its validity may be open to some question.

In view of the great importance of this problem to commercial banks, whose loans and discounts generally constitute their most important single asset, the general statutory reserve method as administered was found to be most unsatisfactory. Bank representatives pressed for a new bad debt reserve method; their efforts culminated in the release of Mimeograph 6209 and a series of amplifying Rulings.

Reserve methods for banks

Where the taxpayer is a "bank," the moving-average and alternative methods provide formulas for computing reasonable annual additions to such reserves. While it would seem that a bank should be allowed to use the general statutory reserve method without regard to the limitations imposed under the moving-average and alternative methods, the Commissioner has taken the position that a bank using the general statutory reserve method is subject to the maximum annual deduction and ceiling limitations of the moving-average method as set forth in Mimeograph 6209.

Moving-average and alternative methods

The procedures for applying the moving-average and the alternative methods are substantially identical, differing principally in the manner of selecting the 20-year average-loss-experience period. The first step in applying either method is the determination of the average-loss-experience factor, which is the percentage of net bad-debt losses to outstanding loans over the appropriate loss-experience period. This factor is then applied to total loans outstanding at the end of each taxable year to determine, subject to ceiling limitations, the amount of the deduction from gross income on account of the reserve addition for the year. The amount thus determined is deemed to be a "reasonable" addition to the reserve.

If the moving-average method is employed, the loss factor is based upon net bad-debt losses and total outstanding loans for the 20-year period ending with the close of the taxable year for which the reserve addition is computed. As the name indicates, a moving-average factor is computed for each taxable year. Where the alternative method is used, however, the factor is computed on the basis of the taxpayer's experience over any 20 consecutive years of its existence since 1927. While the loss factor of a bank employing the alternative method may remain relatively constant, the Rulings do not expressly preclude a bank from changing its loss experience period, and thus its loss factor, in any year.

Following the release of Mimeograph 6209, the question arose as to whether the loss factor should be computed by aggregating 20 annual percentages of net bad debts to outstanding loans and dividing the sum by 20, or by totaling net bad debts for the entire 20-year period and dividing that total by the aggregate year-end loans for the period. Since no specific procedure was prescribed, the Bureau allowed an election to compute the factor upon either basis, but required that the basis adopted be consistently used in future years.

Comparable loan used

In making these computations, only those loans are to be used which are "comparable in their nature and risk" to loans outstanding at the close of the current taxable year. Moreover, bad-debt losses are to be reduced by recoveries during the loss experience period. The data used are to be derived from the taxpayer's own experience, with the exception of newly organized banks and others lacking the necessary experience. In such cases, "comparable data" may be used, subject to adjustment of the resulting reserves as each bank's own experience is determined.

The factor thus computed is applied to total loans outstanding at the close of each taxable year, producing an amount which is considered "indicative of the probable annual accruing loss." This amount is deemed a "reasonable addition" to the reserve for that year, if within the ceiling limitations. The full amount of the permitted addition need not be added to the reserve, however, if the taxpayer desires to postpone the time when its reserve ceiling will be reached.

Ceiling limitations

To prevent the indefinite accumulation of reserve additions "simply because of the possibility that at some future date large losses may be concentrated within a relatively short period of time and operate to absorb the greatest probable reserve," ceiling limitations have been placed on bad-debt reserves under the moving-average and alternative methods. When the reserve reaches the prescribed ceiling, no further deductions from gross income are allowed for bad-debt-reserve additions until changes in the components of the formula under the method adopted permit further additions.

The basic ceiling on bank bad-debt reserves for any year is an amount equal to three times the product of the currecent loss factor and the amount of loans outstanding at the end of that year. While this limitation will not affect the allowable deduction for the year in which the reserve method is adopted, in subsequent years it may reduce or eliminate deductions from gross income with respect to the bad-debt reserve.

Net bad-debt losses

The moving-average loss factor is computed on the basis of *net* bad debts during the loss-experience period, determined by deducting from gross bad debts the amounts of recoveries made on bad debts of prior years. The same rule undoubtedly applies in computing the loss factor under the alternative method.

Losses which properly do not fall into the bad-debt category or which do not result from transactions closely akin to the ordinary course of a bank's current business may not be included in its loss experience.

What are loans?

In applying either the moving-average or the alternative method a bank must determine, for two purposes, which of its assets properly may be classified as "loans." The computation of the average-loss factor utilizes total year-end loans outstanding in each of the 20 years of the appropriate loss experience period. Also, the determination of the allowable addition to reserve in each year requires determination of the amount of loans outstanding at the end of such year.

Despite the importance of the term "loans" the Service has clarified its meaning only to a limited extent. Clearly, only bona fide loans may be included. Intentional overdrafts and amounts due from customers failing to meet their liability under letters of credit should be includible in loans. Loans which have become war losses probably should be classified as "loans" even though the war losses themselves may not constitute bad debts.

"Government insured loans" are to be excluded from loans for the purpose of computing the average-loss factor and the annual reserve additions. While the Service has declined to specify the particular types of loans which are to be excluded, it has ruled generally that only fully insured or fully guaranteed loans are to be excluded.

"Securities," including bonds of the types defined in Section 162 (g) (2) (C) of the 1954 Code, are not "loans" for purposes of making bad debt reserve computations. As to these and other "securities" held by banks, the Internal Revenue Code authorizes the deduction of losses through either the specific charge-off method or through additions to a separate reserve. The election to use a reserve for losses on securities is made independently of the election to use the reserve method of reflecting bad debt losses.

In addition to determining what items constitute "loans," a bank must also determine, for purposes of computing its loss factor for any year, whether those items selected are loans "comparable in their nature and risk involved to those outstanding at the close of the current taxable year."

Interpreted literally, this would seem to require classification of all loans during the appropriate 20-year experience period, comparison of each type with loans outstanding at the close of each current taxable year and similar classification and comparison in each taxable year for which the moving-average or alternative-reserve method is employed. The magnitude and difficulty of this task is apparent when it is considered that the nature of a loan and the risk involved depend upon many factors, including the term and interest rate, the form of the promise, whether collateral is furnished, and if so, the kind of collateral, as well as the nature of the borrower's business and the borrower's status in the industry.

Objections to this concept were voiced upon release of the Mimeograph. It was urged that the vagueness of this provision contrasted sharply with the general purpose of the moving-average method and with the more specific provisions of the Mimeograph in other respects. It was pointed out, also, that the new formula was not expected to produce precise results, but rather to provide a reasonable estimate of future losses based upon rough calculations. The classification of loans by risk is inconsistent with a basic concept of the reserve method in that no particular account or group of accounts is assumed to be uncollectible in whole or in part; the reserve method seeks merely to average the risks shown by the past experience in a bank's entire loan account. Even if risks involved in current loans could be compared on any rational basis with the risks involved in loans made 20 years ago, the value of any such comparison is questionable at best.

Efforts to obtain a change in this limitation were unavailing. The Service did issue a statement, however, to the effect that the "comparable in nature and risk" limitation was not intended as a "trouble-maker" for banks or examining agents, but was intended as "protective language to cover the exceptional case." No change in the objectionable language has been forthcoming, and the dearth of litigation growing out of this provision indicates that it may not have caused the trouble originally anticipated.

Some relief was afforded by an early Ruling. The mere fact that loans of a type which have been a part of the regular business of a bank are completely absent from its outstanding loans at the close of a taxable year does not require that such loans be eliminated from the bank's experience over the 20-year period in the case of banks employing the alternative method, or over the prior 19 years in the case of banks using the moving-average method. In such circumstances, the loss factor need not be recomputed, but in unusual cases, loans may be eliminated and the factor recomputed if the absence in the current year of loans included in the 20-year experience period will produce a "substantial effect" upon the reserve addition. This may occur, for example, where a bank takes over from a predecessor bank a substantial amount of foreign loans of a type which has never been a part of the business of the acquiring institution. Although resulting losses might be deductible as bad debts in the year of loss, if the inclusion of such loss in the 20-year experience computation had any substantial effect on the 20-year moving average, it should be eliminated as not being comparable to the regular business of the acquiring bank. ☆

Switching to Lifo? Beware that you do not have same fiscal year that big buyers have

IF A LIFO USER dips into his low-cost inventory, he must replace it by the year-end to avoid a big profit and a big tax. The tax man for a LIFO company always worries when the inventory drops below the opening figure. His firm is in a bad way if it is going to have to compete with other LIFO users in a scramble to build their LIFO inventories at the same date. If you're contemplating a switch to LIFO, this is a problem you want to examine carefully. For example, the copper market was pushed sky-high largely because the big buyers were all rebuilding LIFO inventories at the same time in 1955. Waino W. Suojanen, Assistant Professor of the University of California in Berkeley, did an analysis of this in an article in *The Accounting Review*. The following brief excerpts give you the picture:

From a practical, managerial point of view, LIFO possesses a very real advantage. To conserve funds by paying lower taxes is one if the aims of almost every corporation that adopts LIFO.

However, the firm that uses the elective method encounters a rather serious problem of inventory management in periods when prices are rising. It must not have a smaller inventory on hand at the end of an accounting period than it had at the beginning of that same tax year. Assume, for instance, that at the beginning of 1955 a company had two million pounds of copper on hand, valued at 13 cents a pound, the cost of copper in 1945 when the firm adopted LIFO. At the end of 1955, the administered price of copper was 43 cents a pound. Suppose further than by the end of 1955 management had permitted the inven-

tory to run down to a million pounds. The result is obvious: profits are "overstated" by $300,000 and the corporation is forced to pay 52% or $156,000, in Federal income taxes. If management had not permitted the LIFO "base stock" to be reduced by a million pounds, the above would not have occurred. This, of course, is elementary accounting, but it has far broader implications.

Case study in October 1955

According to a case study published in the *Wall Street Journal* of January 3, 1956, the average price of copper in the last half of 1955 was the highest it had been since the Civil War. Apropos of this, the *Wall Street Journal* argued that "only inventory buying for tax purposes supported the extremely high price" of metal in the late months of 1955. That year was marked by a very high level of business activity. The supply of copper was far outstripped by the demand. Strikes in the U. S. and elsewhere in the world reduced the amount of copper available for manufacturing purposes, while the stockpiling requirements of the Federal Government were added to the very heavy industrial demand. Because demand considerably exceeded the supply, the pressure on copper prices throughout the year was upward.

At the end of 1954, all of the four major integrated producers of copper and the two leading brass fabricators used LIFO and were on a 12/31 year. In addition, three dominant producers of electric appliances and machinery, which have large inventories of copper and copper products were also using LIFO for inventory-valuation purposes and also used a 12/31 year.

The inflationary effects of lifo

In view of the argument that LIFO exerts a stabilizing effect on the economy, the following quotation from the trade literature is pertinent.[1]

"The inventory shortage is of two sorts: the ratio of inventories to fabricating operations is well below that which most fabricators feel is advisable, and for many firms inventories built in earlier years at prices at low as 12¢ have been reduced and profits for calculating income taxes will need to reffect the spread between these low prices and current high prices of fabricated products . . . The shortage of fabricator stocks as a ratio of operations is probably about 65,000 tons in the U. S. . . . The shortage of copper for LIFO purposes may be about 25,000-35,000 tons."

On October 3, 1955, *The Wall Street Journal* had the following comment on the copper situation.

"A prediction that copper supply and demand may attain a "rough balance" in the fourth quarter was made last week by the Business and Defenses Services Administration in Washington. It noted, however, that the forecast was based on the assumption that output would not be interrupted, curbs on copper exports would continue, and copper scheduled for delivery to the stockpile in the fourth quarter be deferred.

"The B. D. S. A. emphasized that although there probably will be enough copper to meet fabricators' needs for immediate consumption, there won't be enough to rebuild exhausted inventories."

In the light of the above two observations, it is evident that there was only enough copper available during the latter half of 1955 to supply current industry requirements. Roughly 90,000 tons more were needed: (1) to build up depleted inventories in order to bring them into line with current sales and (2) to meet the LIFO "base stock" needs of copper producers and fabricators.

Discussions with trade sources and a study of newspapers and trade journals suggest that the upward pressure on the prices charged by custom smelters for reprocessed copper during the last third of 1955 was caused mainly by buying to build up LIFO "base stocks." That is, 30,000 tons of the 90,000-ton shortage of copper during this period was not a real demand—it was an artificial demand occasioned by the fact that, except for Western Electric Company, the large producers and fabricators of copper were on a LIFO basis and had fiscal years ending on December 31.

This brings up the very legitimate question as to whether LIFO was the villain in the cast. Assuming that the leading copper producers and fabricators were on a FIFO basis, the 30,000-ton shortage for "base stock" replacement purposes would not have existed. Similarly, if the major producers and fabricators had been on a LIFO basis but had had fiscal years ending on different dates, the upward pressure on prices would have been weaker during the months under consideration. Instead, a revolving inventory "float" of say 3,000 tons would have sufficed to meet the average, "base stock" replacement needs of the corporations concerned. In either of the above cases, the upward pressure on both secondary and primary copper prices would have been less. ☆

[1] *Engineering and Mining Journal*, November, 1955, p. 69.

New accounting decisions this month

CAPITAL GAINS

Ordinary gain on sale of breeding cattle held primarily for sale. Taxpayers, owners and operators of a farm, sold registered breeding cattle to breeders at the farm, at auctions, and at exhibitions. They advertised their cattle in breeders' periodicals. As the primary source of their income during the years at issue was from the sale of registered cattle, the court holds the sales were made in the ordinary course of business and not from a "breeding herd." Profit derived from such sales was therefore ordinary income and could not be treated as gain from the sale of capital assets. *Schudel*, TCM 1957-54.

Out-of court settlement was for loss of profits; was ordinary income. Taxpayer, a tenant of a variety store, obtained from his landlord an option to rent two adjoining stores when the latter's leases terminated. Before the time arrived for exercising the option, the landlord sold the property to the owner of one of the adjoining stores. Taxpayer was forced to vacate the premises and to move to a more expensive location. He brought suit against the former landlord for recovery of damages for loss of profits and incurred rental expenses. The suit was settled by the landlord's payment to taxpayer. The court holds the payment is ordinary income. Taxpayer's claim was based on loss of profit due to increased rent expense elsewhere; no capital asset was involved because taxpayer, as optionee, possessed nothing more than a mere expectancy. *Booker*, 27 TC No. 115.

Jury finds patent was sold (1939 Code). Taxpayers assigned patent rights within certain geographical areas. In determining whether taxpayer could report his "royalty income" as capital gain, the

jury was instructed to determine whether all the substantial rights to the patent were transferred. If taxpayer transferred less than all the substantial rights secured by the patent, to make, use and sell the patented article, for the entire period of years covered by the patent, the transaction would be a lease and not a sale. The jury finds capital gain treatment proper. The provisions of the contracts are not reported. *Buckley,* DC Wash., 1/30/57.

Lawyer realized ordinary income on sale of subdivided lots. Taxpayer, a lawyer who derived most of his income from rentals and investments, owned a one-third interest on a land tract. He purchased interests in adjoining tracts for the alleged purpose of bringing utilities to best advantage. The court finds that the interests in the adjoining tracts were purchased with the intention of subdividing, improving, and selling the property by lots to customers. Profit from the sale of such lots are held taxable as ordinary income. *Cornish,* TCM 1957-61.

Lawyer selling subdivided land acreage is in real estate business. A lawyer who had acquired acreage for development was, the Tax Court found, holding the lots for sale to customers in the ordinary course of his trade or business and was precluded from capital-gains treatment even though most of the activity was handled by a real estate agent. In the two years in issue, 159 lots were sold with transactions occurring three times every month on the average. This court affirms. *Gamble,* CA-5, 3/21/57.

Cancellation of stockholder's debt is dividend. Taxpayer, who owned substantially all the stock of a corporation, agreed on February 10, 1948 to sell the stock for $4 million minus net current liabilities as shown on the books on February 28, 1948. Some time between those dates, the corporation canceled taxpayer's debt to it of about $34,000. The corporation and taxpayer originally treated the cancellation as a dividend. Taxpayer here argued that the cancellation resulted merely in a decrease of his sale price for the stock; the result was the same as if he had received a larger price (because the account was still a current asset of the corporation) and then had paid the debt. Thus he argued that the forgiveness was part of the purchase price of the stock and as such was capital gain. This result the court reached in 20 TC 505, but the Fifth Circuit remanded to determine the date of cancellation. The court now finds it occurred before February 29, while taxpayer was a stockholder; therefore it was a dividend and the cancellation could not qualify as a distribution from a depletion reserve because there were sufficient earnings and profits in the taxable year to cover the amount of the canceled debt. *Wilson, Jr.,* 27 TC No. 119.

Assembling phosphate acreage for salable parcels is a business. A cattle rancher, timber grower, and real-estate broker realized profits from sales of phosphate-bearing acreage which, by purchase and options over a period of years he assembled into parcels sufficiently large to attract a customer. The sales are denied capital gain treatment. The court holds the taxpayer acquired, and at all times held, his interest in the lands primarily for sales to customers; and that his extensive activities in examining and prospecting the acreage, raising money for their acquisition, negotiating and making actual purchases to assemble saleable parcels, and negotiating for their sales constituted the carrying on of a business. The fact that taxpayer consumed a much greater portion of his time in his cattle ranching and timber growing ventures is immaterial. His handling of the acreage was a business. *Thomas,* 28 TC No. 1.

Inventor retained substantial rights; transfer was a license, not a sale. Taxpayer-inventor transferred his patents to a corporation created by his employer. However, he retained the right to license any subsequent employer if he left this employer. The court holds that taxpayer retained such substantial rights that the transfer was a license, not a sale, and that the payments he received are ordinary income. *Watkins,* DC Conn., 3/12/57.

Ordinary income on substantial sales of livestock never in breeding herd. Taxpayer made sales of cattle which were less than 26 months old and which were never used in a breeding herd. The court holds the sales resulted in ordinary income, not capital gain. The sales were substantial and widely advertised. The whole method of operation showed that selling cattle was a substantial part of taxpayer's business. He did not merely maintain a breeding herd from which a few culls and inferior animals were sold from time to time. *Clark,* 27 TC No. 124.

Payment for relinquishment of distributorship rights ordinary income. Taxpayer was the exclusive distributor of certain storm windows in three states. He received $17,000 in connection with his relinquishment of rights under the distributorship agreement. Noting that the record is scanty, the court holds there was no sale or exchange and the payment is ordinary income. *Skannel,* 27 TC No. 118.

Employee of wire firm, also wire consultant, has capital gain on wire bought for speculation. Taxpayer was the chief production engineer of a corporation engaged in the manufacture of insulated wire, and he also conducted an experimental laboratory as a sole proprietorship to test various plastic compounds as insulating material for TV lead-in wire. Occasionally he sold certain usable portions of the experimental electrical wire to reduce the cost of his experiments. During the taxable year, taxpayer purchased one million feet of television wire which he segregated from the experimental wire and carried in his records as a speculative investment. The court holds the purchase had no relation to his employment or to his experimental activities. Sale of the wire at a gain resulted in capital gain and not ordinary income since the wire had not been held primarily for sale to customers in the ordinary course of taxpayer's business. *Nehring,* TCM 1957-51.

Call not substantially identical to stock; special short-sales rules not applicable. The Code provides special rules (Section 1233) to prevent the conversion of short-term to long-term gains by the device of selling short a security held for less than six months and covering later by delivering the security when it is six months old. The rules apply if a taxpayer sells short while holding "substantially identical" property. The Service holds, reversing a ruling of 12/10/54, that a call (a contract permitting—but not obliging—the holder to buy a security at an agreed-upon price) is not substantially identical with a security. Section 1233 does not apply to securities sold short while a call on them is owned. *Spec. Rul.* 2/27/57.

DEDUCTIBILITY

Interest payable out of profits accrues when profits are earned. When taxpayer's preferred stock was sold to investors in 1925, the holders of the common stock guaranteed that the preferred would receive dividends for four years. Taxpayer actually paid about $800,000 to preferred stockholders under this agreement, and agreed to repay the common stockholders for the advance, plus interest. In 1940, the taxpayer accrued the full amount of interest, about $450,000, on the ground that not till then did it have profit out of which to pay the interest. The court finds the interest accrued in 1939. The agreement provided that reimbursement should not be made "except out of profits" of taxpayer. Taxpayer argued that this meant profits after deduction of the preferred dividends, and since dividends in arrears were paid in 1939 there was nothing left to meet the liability for the 1925-29 debt and interest. Only when 1940 earnings came in was taxpayer required to make payment and only then did interest accrue. In a somewhat confusing discussion of the difference between profit and undistributed surplus, the court holds that the word profits in the agreement has its usual meaning, i.e., without deduction of dividends. The liability to repay arose in 1939 and interest accrued then. *American Bemberg,* DC Del., 3/21/57.

Payments were cost of stock, not interest. Taxpayer had an option to buy certain stock. A family corporation actually bought it and gave him an option to buy it (apparently after inherited funds would be available to taxpayer). Taxpayer guaranteed the corporation against loss and that it would have a certain income; should the income be higher the excess would reduce taxpayer's option price. Actually its income fell below the guaranty and taxpayer paid the difference and claimed it as interest. The court finds it was additional purchase price of the stock. Taxpayer was not indebted to the corporation; hence he could not incur interest. *Patton,* DC Wisc., 3/7/57.

Cash-basis taxpayer can't deduct accrued income tax for Section 102 tax (old law) [*Certiorari denied*]. The Commissioner assessed a surtax under Section 102 for 1946. The corporation's 1945 income taxes, paid in 1946, amounted to $142,000. This is the amount it can deduct. It cannot deduct its 1946 income tax of $726,000. The 1939 Code provision allowing deduction of taxes "paid or accrued" must be interpreted, as in other part of the Code, as meaning according to taxpayer's method of accounting. The Supreme Court so held in *Olympic Radio & Television* in denying an accrual-basis taxpayer the right to deduct taxes when paid in computing operating losses. [1954 Code allows a cash-basis taxpayer to deduct accrued income tax. *Ed.*] *Harry M. Stevens, Inc., cert. den.,* 3/25/57.

Owner's cancellation of indebtedness a contribution to capital. Taxpayer, an officer-stockholder of an insurance company which was in poor financial condition, agreed at the request of the State Department of Insurance to cancel the company's indebtedness to him for accrued salaries. The court sustains the Commissioner's disallowance of the loss claimed by the officer. The cancellation was a contribution to capital, not a deductible expense. *Backer Estate,* TCM 1957-47.

Payments to induce stockholder to sell deductible; ordinary and necessary, though unusual. A 50% stockholder of taxpayer-corporation died, leaving his stock to his widow. The corporation, an insurance agency, had to replace the services of the deceased officer-stockholder or lose some of its agencies. The widow wouldn't approve the man whom the insurance companies were willing to accept. The corporation agreed to pay the widow $100 per month for the rest of her life if she would sell her stock to the new man. She sold the stock for $15,000, which the court holds was a fair price. The payments were not part of the sales agreement, nor were they a disguised dividend. They were deductible expenses. *Williams & Waddell, Inc.,* DC S. C., 2/27/57.

Didn't prove machinery was second-hand; Bulletin F depreciation upheld. For the type of machinery involved, Bulletin F prescribed a 15- to 25-year depreciation life. Taxpayer claimed that a rate based on a ten-year life was justified for used machinery. The court holds that taxpayer failed to sustain his burden of proof: taxpayer's books didn't indicate whether the machinery was new or used, and no effort was made to determine the date of manufacture of the machinery. The testimony by a foreman that in his estimation the machinery had been in use for five years prior to purchase by the taxpayer was insufficient proof. *K. O. Lee Co.,* DC S. Dak., 2/27/57.

OTHER ACCOUNTING DECISIONS

Stockholder taxed on wife's share of partnership operating corporation's hotel. [*Certiorari denied*]. Taxpayer owned 51% of the stock of corporation owning and operating a hotel; the manager owned 47%. The corporation leased the hotel to a partnership in which the manager had a 47% interest, taxpayer's wife 47%, and the assistant manager 6%. The Commissioner taxed the wife's partnership income to taxpayer. The court agrees. The lease to the partnership was terminable on 60 days' notice and through his 51% ownership taxpayer controlled the lessor. The wife's money was used for household expenses and payments of husband's debts. Income was really his. *Price, cert. den.* 2/25/57.

Stockholder's advances are nonbusiness debts. Taxpayer organized and developed a passenger airline-service corporation, financed the acquisition by the corporation of a subsidiary aircraft-maintenance company, and purchased a minority interest in a corporation operating a Cuban airline. During his lifetime he advanced huge sums of money to all three corporations. The court holds his losses on these loans are a nonbusiness bad debt. Taxpayer's activities as financial backer were not so exceptional or extensive as to constitute a business separate and distinct from that carried on by the several corporations themselves. *Howe Estate,* TCM 1957-58.

Stockholder's cancellation of accrued interest on indebtedness not gratuitous. A stockholder who had advanced funds to taxpayer upon an interest-bearing note agreed to cancel the accrued interest upon the promise of another creditor to do likewise. The court holds the cancellation of accrued interest was not a gratuitous forgiveness but resulted in income to taxpayer to the extent that it had been deducted in prior years with a tax benefit. *Commercial Freight Lines, Inc.,* TCM 1957-48.

TAX PLANNING AND
Business management
EDITED BY CHARLES S. LOWRIMORE, Sr., CPA

Don't let the corporation's "state of mind" trap it in Section 531 cases

by **ROBERT S. HOLZMAN**

These days, when the courts are so concerned with the corporate "state of mind" in accumulated-earnings cases, the tax practitioner has the added duty of becoming a sort of corporate psychologist. Not only must he watch his client's state of mind to prevent Section 531 troubles, but if the troubles start he must also delve into the directors' motivations so that he can successfully unwind the tax tensions and obtain tax relief. The author here discusses the tax man as corporate psychologist, the recent and important Smoot case, and the earlier case law on the state-of-mind issue, and he concludes with a warning that the burden of proof is still on the taxpayer.

THE PSYCHOLOGIST is a familiar part of the American scene today. In many instances, he can relieve a patient of his tensions and torments by delving into the past: specifically, how were a person's actions shaped by something that was going on in his mind in the distant past?

Application of this principle to taxation is not new. There are many examples of how tax relief is obtained in accordance with one's state of mind. The taxpayer's thoughts may be important in deciding whether a transaction is ordinary or capital, because of the Internal Revenue Code phrase "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."[1] Why was the property really held? If loss is to be deducted, it must be shown that it arose from a "transaction entered into for profit."[2] Was an acquisition made to evade or to avoid income taxes?[3] Was an underpayment due to fraud?[4] This interplay between psychology and taxation has often been recognized in tax literature.[5]

[*The author is a Ph.D., CPA, and is Professor of Taxation at NYU Graduate School of Business Administration. He is the author of numerous articles and books on taxation.*]

The accumulated earnings tax is a prime example of how taxation may depend upon the taxpayer's thoughts. This tax is imposed upon any corporation "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed."[6] Why was the corporation formed or availed of? Furthermore, "the fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary."[7]

It is obvious that the cases involving the accumulated earnings tax, or its forerunners, have been decided upon psychological bases. One court observed that "in this case it is necessary to peer into the mind of the taxpayer to determine its intent."[8] "Purpose, being a state of mind, is always difficult to determine in a proceeding like this."[9] "A statute which stands on the footing of the participants' state of mind may need the support of presumption, indeed be practically unenforceable without it, but the test remains the state of mind itself, and the presumption does nothing more than make the taxpayer show his hand."[10]

The constitutionality of the tax was questioned on the ground that "it is a direct tax on the state of mind." But this the Supreme Court rejected, saying: "The existence of the defined purpose is a condition precedent to the imposition of the tax liability, but this does not prevent it from being a true income tax within the meaning of the Sixteenth Amendment. The instances are many in which purpose or state of mind determines the incidence of an income tax."[11]

The facts in Smoot

The first 1957 case involving the accumulated earnings tax was the *Smoot* case.[12] The court indicated sharply that it is necessary to establish what was in the minds of the directors during the taxable year: specifically, at the time when dividend policy was set or when plans for the utilization of surplus were formulated.

The Service asserted a deficiency based in part upon $451,408.03 accumulated earnings tax. To prove the legitimacy of its surplus retention, the corporation engaged the American Appraisal Company to make a re-appraisal of the taxpayer's financial needs. Allotments were made for future replacements of various assets and for expansion of plants and equipment. Reserves were shown to be required in certain instances.

The Tax Court found in favor of the Government.[13] It said that earnings had been retained beyond the reasonable needs of the business. Appeal was taken on the ground that the Tax Court had ignored testimony of witnesses regarding the evaluation of sums needed for rehabilitation.

Said the Fourth Circuit: "In order to determine whether profits were accumulated for the reasonable needs of the business or to avoid the surtax upon shareholders, the controlling intention

[1] Sec. 1221.
[2] Sec. 165(c)(2).
[3] Sec. 269.
[4] Sec. 6653(b).
[5] Examples are: Ballantine, *Psychological Bases for Tax Liability*, 2 HARV. L. REV. 200 (1949); Fischer, *Intent and Taxes*, 32 TAXES 303 (1954); Sutherland, *Taxpayer's Motives as a Basis for Taxability*, NYU 8TH ANN. INST. ON FED. TAX. 990; Otto, *Section 102, the Tax on a Corporation's Psyche*, 31 TAXES 432 (1953).
[6] Sec. 531(a).

of the taxpayer is that which is manifested at the time of the accumulation, not subsequently declared intentions which are merely the products of afterthought." The inadequacy of reserves as determined subsequently by the American Appraisal Company and the legitimate capital required for expansion as brought out by that company's studies were deemed to be completely irrelevant, for the directors' policy could not have been actuated by figures prepared three years later.

On appeal, the corporation also complained that the Tax Court had refused to recognize the reality of a reserve for entry into a new business. Throughout the taxable years, it claimed, there was a threat from customers that they would enter into competition with the corporation in the sand and gravel business, unless substantial price concessions were granted. These threats and demands were met during that period by the corporation's insistence that if unduly pressed, it would enter the ready-mix concrete business in competition with certain of its customers. The upshot was that the corporation had to be in position to make good its threat: that is, it had to be prepared financially to enter the ready-mix business. The Tax Court would not recognize that a reserve for such a need was reasonable, as "petitioner never planned or intended to go into the ready-mix business of its own free will, and the contingency which might have forced it to do so never developed." The Fourth Circuit, however, was interested only in the thought processes of the taxable years. "What is material is whether or not petitioner reasonably believed that it might have been forced into the ready-mix business as a defensive measure, and whether it reasonably intended to enter such business when and if the imminence of the threat should demand it. The fact that such a step would be taken involuntarily would not make the need less compelling. If the petitioner reasonably feared the contingency it had the right to protect itself by providing a reserve for this purpose."

So the case was remanded to the Tax Court to decide "whether petitioner reasonably believed that it would likely be forced into the ready-mix business during any of the taxable years in question and, if so, what sum was needed therefor. The measure of the capital needed for such a purpose would be the extent and degree to which petitioner intended to engage in ready-mix activities and not the cost required to enter the business on the same scale as some other particular ready-mix concerns."

Here is peering "into the mind of the taxpayer" with a vengeance. Accumulations can no longer be justified by reports or recommendations of accountants, attorneys, bankers, economists, engineers, and others which were made after the taxable year. The issue must be decided upon what can be proved to have been in the directors' minds when corporate policies were set. What was thought of during the taxable year is all that matters.

Is the burden shifted?

This restriction makes the burden of proof all the more important. According to Section 534(a), the burden must be borne by the Secretary of the Treasury if the corporation files a statement of the grounds of reasonable retention within the statutory period. Superficially, this seems to shift the burden of proof to the Government. Actually, that may not be the case at all. If the taxpayer does not include in his statement "facts sufficient to show the basis thereof," the burden is not shifted; that language is sufficiently broad to mean that the taxpayer's "statement" must be as thoroughly documented as his brief in an old Section 102 case. Furthermore, the case will still stand or fall on the strength of the taxpayer's basic reason, regardless of who tries to knock down whose argument. Since it must be assumed that taxpayer and Government have equally good counsel, the case will still be decided upon the old issue of how good the reason for retention is.[14] So if the proof of what was in a taxpayer's mind in the taxable year is virtually impossible to establish, that problem is not the Secretary's but the corporation's.

Thus the corporation may have to rely upon the tools of latter-day psychology. In the *Smoot* case, it was held that the directors could not have been motivated by an appraisal report that was prepared three years after the latest taxable year. But perhaps it may be argued that the directors' motivation in the taxable year was subconscious. Or extra-sensory perception may have been involved. With this sort of thing going on, the director or taxman may have to rush to his own psychologist.

Postscript for directors and taxmen: Payments to qualified psychologists come within the definition of medical care for the purpose of the allowable medical expense deduction. *Rev. Rul.* 143, 1953-2, CB 448. ☆

[7] Sec. 533(a).
[8] DeMille Productions, 30 BTA 826 (1934).
[9] Nipoch Corp., 36 BTA 662 (1937).
[10] United Business Corp. of America v. Comm'r, 62 F2d 754 (2d Cir. 1933).
[11] Helvering v. National Grocery Co., 304 U.S. 282 (1928).
[12] Smoot Sand and Gravel Corp. v. Comm'r, F2d (4th Cir. 1957).
[13] TCM 1956-82, filed April 10, 1956.
[14] For a development of this argument, see HOLZMAN, THE TAX ON ACCUMULATED EARNINGS

Miscellaneous new decisions this month

Unitization agreement not an exchange; does not effect a new depletable unit. Taxpayer, which held two separately depletable oil producing properties, claimed percentage depletion on one and cost depletion on the other. It entered into a unitization agreement with five other companies providing for the consolidation of all their producing properties under centralized production management. Each company was to receive its respective share of oil from the whole pool. The court overrules the Commissioner's contention that the unitization agreement constituted a tax-free exchange by taxpayer of its rights in the two properties for a new and separable depletable economic unit, and it holds each participant had exactly the same interests and rights in its respective properties after unitization as before. Taxpayer is therefore permitted to continue to claim percentage depletion on that part of the unitized oil production attributable to the first property, and cost depletion on the part attributable to the second. *Belridge Oil Co.*, 27 TC No. 128.

Must consider salvage value in depreciating livestock, though industry generally ignored it. Taxpayers, owners of a breeding herd, depreciated the animals over their useful breeding lives. The court holds that their estimated salvage value when they cease to be part of the breeding herd must be deducted in computing depreciation. Bulls and cows were marketable as livestock after they had no value for breeding. Evidence that the practice of taxpayers and agents throughout the area was to ignore salvage values is rejected by the court as immaterial. *Koelling*, DC Neb., 2/14/57.

INCOME TAXATION OF

Trust & estates

A simplification of the complex rules governing the status of simple trusts

by JOSEPH HAWLEY MURPHY

The Code's definition of a simple trust is seemingly a model of clarity. A simple trust distributes all of its income, the Code says. But that's where the clarity ends. Many complexities surround this definition and the Regulations on this area of the Code. We asked Mr. Murphy to comment on the new Regulations affecting this question. He is a partner of the Syracuse, New York law firm of Hancock, Dorr, Ryan & Shove and professor of law at Syracuse University.

UNDER CODE Section 651, a simple trust is one which by its terms must distribute all of its income[1] currently and which does not provide that any amounts are to be paid, permanently set aside, or used for charitable purposes. The requirement that the trust income be distributed currently is given a fairly lenient interpretation in the Regulations. For example, the trustee may retain necessary reserves and still be considered distributing currently. The test seems to be that there must be a duty to distribute the income currently even if, as a matter of practical necessity, the income is not distributed until after the close of the trust's taxable year.[2]

A trust is still simple even though capital gain is allocable to corpus. What is income is determined by the instrument and local law; if capital gains are not income by those criteria, there is no requirement that a trust distribute them in order to remain simple.

Nor is it necessary that the amount of income allocated to particular beneficiaries be specified in the instrument. For example, if the fiduciary is required to distribute all the income currently, but has discretion to "sprinkle" the income among a class of beneficiaries or among named beneficiaries in such amount as he may see fit, all the income is required to be distributed currently, even though the amount distributable to a particular beneficiary is unknown until the fiduciary has exercised his discretion.[3]

A trust may be "simple" in one year and "complex" in another year. For example, a trust under which income may be accumulated until the beneficiary is 21 years old, and thereafter distributed currently, is a simple trust for the taxable year beginning after the beneficiary reaches the age of 21 years.[4]

However, a trust is not qualified for treatment as a simple trust for any taxable year in which it makes an actual distribution of corpus. For example, a trust which is required to distribute all of its income currently would not qualify as a simple trust under Section 651 in the year of its termination, since in that year actual distribution of the corpus would be made.[5]

Similarly, where corpus may be distributed in the discretion of the fiduciary, a trust will not qualify as a simple trust in any year in which such a distribution of corpus is made.[6] This would be the situation with a trust where certain portions of the principal were required to be distributed to the beneficiaries upon attaining certain ages. In the year in which those ages were attained and the distribution of principal made, the trust would not qualify as a simple trust but would be a complex trust. A trust with income currently distributable to private beneficiaries and the remainder to a charitable organization is not complex if there is a contingency that the remainder will not go to a charity. In that case, additions to it are not "set aside for" charity. If the charitable remainder is vested, the trust may still be simple in a year there is no addition to corpus of income for which a charitable deduction is allowed.[7]

If a trust qualifies as a simple trust, it is allowed a deduction for the amount of income which the trust instrument requires to be distributed currently to beneficiaries.[8] If, however, that amount exceeds the distributable net income, the deduction allowable to the trust is limited to the amount of the distributable net income.

For this purpose, the amount of income required to be distributed currently or distributable net income, whichever is applicable, does not include items of trust income which are not included in the gross income of the trust.[9] For example, assume that the distributable net income of the trust as computed under Section 643(a) amounts to $99,000 but includes nontaxable income of $9,000. The distributable net income for the purpose of determining the allowable deduction under Section 651 is $90,000.[10]

Generally speaking, a beneficiary of a simple trust includes in his gross income for the taxable year the amounts of income required to be distributed to him for such year, whether or not they are distributed.[11] For example, the income of a simple trust is includible in the beneficiary's gross income for the taxable year in which it is required to be distributed currently, even though as a matter of practical necessity, the income is not distributed until after the close of the taxable year.[12] Income required to be distributed currently which is in fact used to discharge or satisfy any person's legal obligation is considered income distributed currently. [13]

[1] The 1954 Code contains several "income" concepts. They are "taxable income," "distributable net income," "undistributed net income," or "gross income." When the Code uses the term "income" alone, it means the amount of income of an estate or trust for the taxable year determined under the terms of its governing instrument and applicable local law.

[2] U. S. Treasury Reg. section 1.651(a)-2.
[3] U. S. Treasury Reg. section 1.651(a)-2(b).
[4] U. S. Treasury Reg. section 1.651(a)-2(c).
[5] U. S. Treasury Reg. section 1.651(a)-3.
[6] U. S. Treasury Reg. section 1.651(a)-3(b).
[7] U. S. Treasury Reg. section 1.651(a)-4.
[8] Int. Rev. Code section 651(a).
[9] Int. Rev. Code section 651(b).

Where a distribution of income is in excess of distributable net income of the trust, each beneficiary includes in his gross income his proportionate share of such distributable net income.[14] For example, if beneficiary A is to receive two-thirds of the trust income and B is to receive one-third, and the income required to be distributed currently is $99,000, A will receive $66,000 and B, $33,000. However, if the distributable net income is only $90,000, A will include $60,000 of that sum in his gross income and B will include $30,000 in his gross income.[15]

Income distributed to the beneficiaries has the same character in their hands as it did in the hands of the trust.[16] This is worked out on a proportionate basis. To illustrate, assume that under the terms of the governing instrument A is to receive currently one-half of the trust income and B and C are each to receive currently one-quarter. The distributable net income of the trust consists of dividends of $10,000, taxable interest of $10,000 and tax-exempt interest of $4,000. A will be deemed to have received $5,000 of dividends, $5,000 of taxable interest and $2,000 of tax-exempt interest. B and C will each be deemed to have received $2,500 of dividends, $2,500 of taxable interest, and $1,000 of tax-exempt interest.[17]

Of course, the terms of the trust can provide for a different allocation, in which event that will prevail.[18] The terms of the trust must make this allocation specifically. If it is made pursuant to discretion granted the fiduciary, it would not be considered a specific allocation within the meaning of this section.[19]

Section 652(b) leaves the matter of the allocation of deductions up to Treasury Regulations. The new Regulations provide that all deductible items directly attributable to one class of income must be allocated thereto.[20] Deductions which are not directly attributable to a specific class of income may be allocated to any item of income, including capital gains, utilized in computing distributable net income, but a portion must be allocated to nontaxable income, if any.[21] Where the deductions directly attributable to a class of income exceed that income, they may be allocated to any other class of income, including capital gains, in the manner prescribed for the allocation of deductions not attributable to any particular class of income.[22]

Section 652(c) of the Code provides that if the taxable year of the beneficiary differs from that of the trust, the amount which the beneficiary is required to include in gross income is based upon the amount of income of the trust for any taxable year or years ending with the beneficiary's taxable year. This is applicable to taxable years of normal duration as well as to so-called short taxable years.[23] In this regard, it is the trust's method of accounting which controls and not the method followed by the beneficiary.[24]

If the beneficiary of a simple trust dies during the taxable year of the trust, the trust's taxable year may not end with or within the taxable year of the beneficiary. The distributable net income of the taxable year of the trust determines the extent to which the income required to be distributed currently to the beneficiary is included in his gross income for his last taxable year or in the gross income of his estate.[25] For example, the gross income for the last taxable year of the beneficiary on a cash basis includes only income actually distributed to the beneficiary before his death. Income required to be distributed, but in fact distributed to his estate, is included in the gross income of the estate.[26] ☆

[10] U. S. Treasury Reg. section 1.651(b)-1.
[11] Int. Rev. Code section 652(a).
[12] Int. Rev. Code section 1.652(a)-1.
[13] *Ibid.*
[14] Int. Rev. Code section 652(a).
[15] U. S. Treasury Reg. section 1.652(a)-2.
[16] Int. Rev. Code section 652(b).
[17] U. S. Treasury Reg. section 1.652(b)-2(a).
[18] *Id.*
[19] U. S. Treasury Reg. section 1.652(b)-2(d).
[20] U. S. Treasury Reg. section 1.652(b)-3(a).
[21] U. S. Treasury Reg. section 1.652(b)-3(b).
[22] U. S. Treasury Reg. section 1.652(b)-3(d).
[23] U. S. Treasury Reg. section 1.652(c)-1.
[24] *Ibid.*
[25] U. S. Treasury Reg. section 1.652(c)-2.
[26] *Ibid.*

New trusts & estates decisions

No operating loss for estate; expenses were nonbusiness. Taxpayer-estate consisted of shares of stock and a tract of timberland. The deductions which gave rise to the claim of a net operating loss consisted largely of interest for late payment of the estate tax, stamp taxes on transfer of stock and Michigan intangible taxes. The other expenses related to the timberland. The only income from this tract was capital gain. The court holds that none of these expenses were attributable to a trade or business regularly carried on by the estate and that consequently they cannot be used to make up a net operating loss. *Fisher Estate,* DC Mich., 3/21/57.

Trust authorized to lease interests to operators; not thereby taxable as a corporation. An investment trust proposes to acquire mineral fee interests as part of its corpus under an agreement whereby the trustee does not have the right to exploit the minerals but may, with the approval of all beneficiaries, lease the property to an operating company for that purpose. The Service rules that such inclusions alone will not result in the investment trust being treated as an association taxable as a corporation. The Service cites *Royalty Participation Trust* (20 TC 466), in which the court stated that the test was whether the business discretion is reposed in the trustee. Here the trustee has no such discretion. *Rev. Rul.* 57-112.

Income from realty specifically taxable to estate. Under the state law, title to property specifically devised passed direct to the devisees, but the property was subject to administration by the executor. The Service rules that income is includible in the gross income of the estate for the period that it is under administration. If the income is devised for charitable purposes, it can be deducted by the estate as a charitable donation. *Rev. Rul.* 57-133.

New estate & gift decisions this month

Transfer of home was in contemplation of death, Florida real estate was not. About a month before he died decedent transferred two building lots in Florida, $1,500 cash and the family home in Connecticut to his sister. He had been in poor health and planned to move to Florida. The cash and the proceeds of the Florida lots were to be used by the sister in remodeling her Florida home so that decedent and his wife could live there; these transfers were not made in contemplation of death. The purpose of transferring the Connecticut home, however, was to keep the ownership in decedent's family which had owned it since revolutionary times. The motive of this transfer was not associated with lifetime

activities. The value of the ancestral home is includible in decedent's gross estate. *Blackman Estate* (*Union & New Haven Tr. Co., Ex'r*), DC Conn., 2/18/57.

Jury finds transfer with life interest retained was for adequate consideration. In 1934 decedent transferred to his wife two farms in exchange for the income from these farms and from two farms which she owned. This transfer with income retained would not be includible in decedent's gross estate if it was made for a full and adequate consideration. The factual question of the adequacy of consideration was left to a jury. After hearing conflicting expert testimony of the rental value of the four farms, the jury found the income interests adequate consideration for the two farms. *Klein Estate*, DC Iowa, 2/8/57.

Court unable to value reversion; excludes property from estate. Decedent made transfers to a pre-existing trust under the terms of which she would have a power to appoint corpus in the event she survived all her children and their issue. This is a transfer intended to take effect at death, but is not taxable in decedent's estate unless the value of her reversionary interest is at least 5% of the value of the trust corpus at her death. Decedent was 85 when she died; her only child was a son aged 64 who had no children and who was married to a woman of 59. Decedent's reversion thus depends on her surviving her son and also on her son's having no children. The latter contingency depends on her son's possibility of remarriage. Finding that there is no reliable actuarial data on remarriage possibilities, the court is unable to value the reversion. It therefore assigns a zero value, excluding the transfers from decedent's gross estate. *Cardeza Estate*, DC Pa., 3/21/57.

Insurance-annuity combination one unit; annuity is retained life estate. At the age of 76 decedent purchased three single-premium life-insurance policies. At her advanced age the insurance could be purchased only in combination with an annuity, so that the total premiums paid for both insurance and annuity were equal to about 90% of the face value of the insurance. Decedent gave the insurance policies to her children. Reversing the district court, this court refuses to view the insurance and annuity separately. The substance of the transaction is indistinguishable from a trust in which decedent retains a life estate. The insurance proceeds are therefore includible in decedent's gross estate as a transfer in which she retained the income for life. *Haines Estate*, (Fidelity-Philadelphia Tr. Co., Ex'r), CA-3, 2/28/57.

Notes on new estate and gift decisions in this department are by Theodore Berger, LL.B., CPA, who practices in Chicago.

Insurance policies delivered to trust, but right to change beneficiaries retained. In 1929 decedent created an irrevocable trust. At the same time he made the trustees the beneficiary of several policies of insurance on his life, and delivered the policies to the trustees. The court holds that he did not assign the policies to the trustees, but retained the right to change the beneficiary. The trustees had a mere expectation which decedent could defeat at any time during his life. The right to change beneficiaries was an incident of ownership in decedent, and the proceeds of the policies are includible in his gross estate. *Willing Estate* (Farwell, Ex'r.) CA-7, 4/4/57.

Taxpayer fails to bring himself within terms of special gift tax relief provision. During the years 1936-40 taxpayer made transfers to a trust in which he retained the right to change the shares of beneficiaries but had no power to revest in himself. He filed no gift tax returns, believing the transfers to be gifts of present interests less than the annual exclusion. In 1939 the Supreme Court surprisingly held in *Sanford* (308 U.S. 39), that transfers such as this were not completed gifts until the donor relinquished power to change beneficiaries. Accordingly, taxpayer treated the termination of the trust in 1946 as a completed gift and paid the tax.

In the meantime, Congress had enacted Section 1000(e) of the 1939 Code as a special relief provision. This section gave persons in the taxpayer's situation an election to treat the original transfer as a completed gift if a gift tax return was filed at the time of the creation of the trust. This court refuses to apply the provisions of Section 1000(e) to the taxpayer because he did not file gift tax returns when he made transfers to the trust in 1936 and later years; furthermore, returns were required since the interests of the beneficiaries were future interests. *Supplee*, CA-3, 3/28/57.

No right to trust corpus retained; could not be reached by decedent or creditors. Decedent transferred securities in trust, reserving $100 a month to be paid him for life out of income or corpus. The trustee could make additional distributions to him out of either income or corpus at the trustee's sole discretion. The estate conceded that the portion of the corpus necessary to pay the $100 monthly annuity, about $50,000, was includible in decedent's gross estate. The Tax Court held the balance includible because it was assumed that applicable Indiana law permitted the decedent's creditors to reach the entire corpus; this would be equivalent to a retained right of enjoyment by decedent. This court, reversing the Tax Court, finds that Indiana law permits the creditors to reach corpus only if the trust was created in fraud of creditors. There was no showing of fraud here. The fact that additional distributions to decedent were permitted did not require full taxability of the trust because the distributions were at the trustee's discretion and decedent retained no rights thereto. *Uhl Estate*, CA-7, 3/13/57.

No estate tax on Briton's stock taken over by UK and pledged for war loans. The U. S. estate tax applies to assets of nonresident aliens situated within the U. S. The Code provides that shares of stock of U. S. corporations "owned and held" by nonresidents are taxable. Decedent, a British citizen, held 1.5% of the outstanding stock of the Grace Corporation, a U. S. corporation. In 1939 Britain required its citizens to turn over to the Government their stock in American corporations so that Britain could pledge the stock as security for a war loan. Decedent did so. He retained no right to vote the stock but was entitled to receive the equivalent in sterling of dividends and the proceeds of sale if the stock should be sold to pay the loan. This was the status of the shares when decedent died. Considering these facts, the court concludes that decedent did not, at the time of his death, possess sufficient incidents of ownership in the stock to subject his estate to the U. S. estate tax on the shares. *Grace Estate, City Bank Farmers Trust Co., Ex'r*, Ct. Cls., 3/6/57.

MANAGEMENT OF THE

Professional tax practice

AND PROFESSIONAL AFFAIRS OF LAWYERS & ACCOUNTANTS

Lawyer protests Kentucky Bar's stand on unauthorized practice in tax work

THE ACTION taken by the Unauthorized Practice of Law Committee of the Kentucky State Bar Association in declaring that "the minute a single act is done to a tax return the party doing so is practicing law" [see 6 JTAX 319] has drawn a sharp protest from Robert Ash, Washington, D. C., attorney. Mr. Ash, a partner in Ash, Bauersfeld & Burton, has been prominently identified with tax practice for many years. He wrote to Victor A. Bradley, Sr., president of the Association, as follows:

Mr. Ash's letter

"I have read with considerable concern the article in the May, 1957, JOURNAL OF TAXATION telling of the plan of your Association to secure a ruling from the Kentucky Court of Appeals on "tax practice." Your Committee on the Unauthorized Practice of Law says that "the preparation and filing of income tax returns . . . constitutes the practice of law." If your Association is successful before the Court of Appeals, only lawyers will be permitted to prepare and file Federal income tax returns in Kentucky.

"In my opinion, your action is in conflict with the public interest. This is so because lawyers do not have the training or qualifications to prepare complicated tax returns properly. I doubt if any of your members could prepare the tax returns of most of the large corporations who file returns in Kentucky. This statement is made based upon nearly forty years' experience as a lawyer specializing in Federal tax practice.

"If your efforts are successful, the result may very well be that many important tax returns will not be properly prepared. This may have a detrimental effect upon the revenues and may subject taxpayers to penalties and unnecessary expense and litigation in an effort to report and pay taxes correctly.

"The mere reading of your Committee's report shows a lack of knowledge of the Federal tax structure and its operation. It states: "The fact that the Federal Government has set up certain Tax Boards, Commissions and Courts . . ." In truth, there are no "Tax Boards" or "Commissions." Federal taxes are administered by a division of the Treasury Department known as the Internal Revenue Service, which is headed by an official known as the Commissioner of Internal Revenue. There is a Tax Court of the United States entirely independent of the Treasury Department.

"The report says that the cards authorizing practice before these "Tax Boards, Commissions and Courts" are used to solicit business. The Treasury Department does issue cards evidencing enrollment to practice before that Department. The Tax Court has its own requirements for practice. Solicitation of business, directly or indirectly, is a basis for disbarment by both the Treasury Department and the Tax Court.

"All persons enrolled to practice before the Treasury Department are subject to rigid and detailed rules governing practice. Among those rules is the requirement that enrolled attorneys must adhere to the canons of ethics of the American Bar Association.

"Your Association would be well advised to thoroughly consider the affect upon the public interest before taking the proposed action." ☆

AIA's annual report comments on tax practice

CONSIDERING the part played by certified public accountants in tax practice, the observations made by their national organization, the American Institute of Accountants, deserve special attention. The following quotations from the annual report of the Institute for 1956 make these interesting points.

Treasury practice

The profession has been seeking answers to . . . fundamental questions. Significant progress has been made in many areas.

Of first importance among these was the clarification of the position of certified public accountants in practice before the Treasury Department. For some time the profession has been disturbed by the implications of various state-court decisions that challenged the extent to which certified public accountants could represent their clients before the Treasury Department. On January 30, 1956, the Secretary of the Treasury released a statement confirming the time-honored right of certified public accountants to represent their clients fully before the Department. Secretary Humphrey's statement was welcomed as a major contribution to an effort already undertaken to resolve differences between the professions by friendly negotiation rather than by litigation or public dispute. In April, committees of the American Bar Association and the Institute met together to lay plans for cooperative efforts to design guideposts that may be needed by both lawyers and certified public accountants in observing the Treasury's admonition to remain within the bounds of their respective professional competences. The relations between lawyers and certified public accountants in actual practice have normally been friendly and cooperative. One of the most helpful developments of 1956, therefore, was the opportunity afforded by Secretary Humphrey's statement for the resumption of the same kind of relationship between the organizations of the two professions.

CPA's ethics

A similar basic review of the profession's rules of conduct has been started this year by the ethics committee of the Institute. What guides can be provided to aid the CPA in determining the extent of his professional competence and responsibility? This question acquires added importance from the Treasury Department's statement of January 30, 1956, which imposes upon CPAs and lawyers an ethical responsibility to respect the field of the other in practice before the Treasury. What are proper standards of ethical conduct for CPAs in tax practice? What are their responsi-

bilities to the taxpayer and the Government? What ethical concepts apply to management services by CPAs? The public has the right to expect the profession to answer these questions.

Opportunities for public service

Certified public accountants also have challenging opportunities to assist in perfecting our income tax structure.

They have already done a great deal. Through its federal taxation committee, the Institute this year submitted more than 200 recommendations for improvements in the 1954 Revenue Code. It reviewed scores of proposed regulations and significant rulings issued by the Treasury Department. It alerted tax practitioners to the problems created by the Code in a series of articles that began in the August issue of *The Journal of Accountancy*. It continued to prepare (and state societies of CPAs continued to distribute) radio, television and printed material that have assisted literally millions of citizens in fulfilling their tax obligations.

Yet much more remains to be done.

There is a growing concern in Washington and elsewhere over the complexity of our tax system and the eroding effect of special provisions enacted to correct inequities or provide economic incentives. This discontent has led to suggestions for a comprehensive and non-partisan study of the whole tax structure—a study, incidentally, which the Institute advocated more than ten years ago. The Institute's tax committee is giving intensive study to this broad problem. CPAs would obviously have a prominent part in any re-appraisal of the tax system. They are in a unique position to evaluate carefully the impact of taxes upon the public and our economy. Moreover, their reputation for independence encourages confidence in the objectivity of their recommendations. Thus the future may hold an even greater challenge to CPAs for public service than the past.

Growth

The Institute continues its steady yet noteworthy growth. At year-end membership had increased to 27,850, an increase of 1,505 during the year; its annual budget exceeds $1.6 million. ☆

Michigan Bar Association forbids lawyers use of title "tax consultant"

USE OF THE TITLE "tax consultant" or "tax specialist" may not be used with propriety by a Michigan lawyer, the Michigan State Bar Association says. In an opinion just published in the Bar's *Journal*, the matter is put this way:

ETHICS OPINION 158

"A lawyer cannot with propriety hold himself out to the public as a "tax consultant" or "tax specialist" whether by special announcement, by displaying upon announcements, signs or door letterings in and about his office to such effect, or by displaying such designation on building or waiting room directories, or any other manner." (CANONS 27, 46).

"A formal opinion has been requested of the Committee on Professional and Judicial Ethics of the State Bar of Michigan concerning the propriety of a lawyer listing on the directory within his waiting room, which is shared with a doctor, the following:

JOHN DOE
Lawyer
Tax Consultant
Hours 9 - 5

Similar questions involving notices by lawyers to the effect that they specialize in tax matters and other branches of the law have frequently received the attention of the committee, and in addition to formal opinions on the subject heretofore published by the Committee on Professional and Judicial Ethics, numerous informal opinions, both written and unwritten, have been furnished over the years.

"However, not only because of the current inquiry but because of the relatively large volume of former inquiries heretofore made, informally and otherwise, it would seem that lawyers generally are still not sufficiently aware of the rules applicable to the situation, for which reason it would seem appropriate to promulgate and cause to be published a comprehensive statement concerning the principles involved so as to reach the attention of the bar generally and for the future guidance of the profession in Michigan.

"Canon 27 unequivocally characterizes as improper solicitation of professional employment by advertising, direct or indirect, excepting only publication of certain data in reputable law listings in a manner consistent with the standards of conduct imposed by the Canons.

"Canon 46, entitled 'Notice of Specialized Legal Services' reads as follows:

'Where a lawyer is engaged in rendering a specialized legal service directly and only to other lawyers, a brief, dignified notice of that fact, couched in legal periodicals and like publications, when it will afford convenient and beneficial information to lawyers desiring to obtain such service, is not improper.'

"In Opinion 124 of this committee we held that 'Federal taxation' did not constitute a specialized legal service within the meaning of Canon 46, and we therein invited attention to Opinion 175 of the American Bar Association Committee on Ethics and Grievances which held that while 'Admiralty' and 'Patents, Trademarks and Copyrights' were recognized legal specialties, the American Bar committee had said in such opinion that any class of work which the average lawyer is equipped and willing to handle cannot be said to be a specialty despite the fact that a lawyer may restrict himself to such a class of work and acquire an unusual degree of proficiency and experience in handling the same.

"Further, in its Opinion 124 this committee went on record as follows:

'While we recognize that one who handles matters of Federal taxation to the exclusion of all other types of law practice may become especially proficient therein, nevertheless this circumstance does not alter the fact that the average lawyer holds himself out as one who is equipped to do this work himself. There may be a marked trend toward specialization in Federal taxation but until such trend is officially recognized by the State Bar of Michigan, our committee should not enlarge the present status by a construction which would include "Federal taxation." '

"It should further be stated that in the application of the main principle this committee perceives no distinction between a lawyer holding himself out as an expert in Federal taxation or as an expert in any other type of taxation.

Far reaching implications

"Recognizing that we are deciding more than the limited facts in the present inquiry as submitted, we feel that until new and sufficient reasons are advanced which may bring about the

general acceptance of new standards so as to cause a change in the American Bar Association limitation heretofore mentioned, and in our opinions previously expressed, we must hold that taxation should not be recognized as an accepted specialty in the practice of law, and that it is therefore improper for a lawyer to hold himself out to the public as such a specialist by displays to that effect upon announcements, signs, doors or building or waiting room directories, or in any other manner." ☆

New practical program to be held at Virginia U., June 20-22

A NOVEL and different kind of tax program is being offered this year at the Ninth Annual Virginia Conference on Federal Taxation. The conference will be held at the Law School of the University of Virginia in Charlottesville, from June 20 to June 22. The sponsors are the Virginia Society of Certified Public Accountants and the University of Virginia.

For the first time, the conference will hold a mock trial before the United States Tax Court. One of the judges of the Tax Court, along with the clerk of this court, will actually participate in the trial. A presentation will be made of the various steps involved in processing a tax matter through the IRS. ☆

PLI releases study on forms of business organization

THE PRACTICING LAW INSTITUTE of New York has just released its new monograph by Russell S. Knapp, *Forms of Business Organization and the Federal Tax Laws*, a 146-page monograph. This is a complete revision and expansion of this popular PLI publication whose first edition appeared nine years ago. The monograph highlights the more important tax considerations which may determine what form of business organization best suits each client's needs. Its purpose is to help lawyers understand the rules applicable to each type of business organization and to recognize its tax problems.

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The author is a member of the New York Bar, and a Certified Public Accountant.

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NEW DEVELOPMENTS IN

Payroll taxes

EDITED BY PETER G. DIRR

The Westinghouse case: Was the employer or the employee deprived of due process?

THE LONG drawn-out Westinghouse strike made newspaper headlines all over the country, and now the unemployment compensation litigation arising out of the strikers' claims for benefits is causing considerable stir. The legal battle is over the "double-affirmation" rule. Pennsylvania, as many other states, requires the payment of unemployment compensation which has been allowed first by the benefit agency and then affirmed by an administrative appeal tribunal, notwithstanding the employer's application for judicial review. The Supreme Court of Pennsylvania found this rule invalid on the ground that it permitted the employer's property to be taken without due process of law[1]

Adjunct Professor Richard H. Wagner of Dickinson School of Law roundly criticized this decision in the *Dickinson Law Review;* he indignantly entitled his protest "Whose Due Process?" As he analyzes the statute, the employer is not hurt, but the employee certainly is.

His first point is that the court misunderstood the operation of the Unemployment Compensation Fund. Payments after two decisions, he points out, do not affect the employer's experience for determining his tax bracket. Nor is it reasonable to say that due process allows any employer in the state to protest any payment that reduces the total cash in the whole fund and causes a uniform rate increase. Finally, the double-affirmation rule is, it seems to him, a reasonable way to solve the conflict between the need to pay the unemployed worker immediately and the need to have review of eligibility decisions.

To prove his point, Professor Wagner first analyzes the working of the Pennsylvania Unemployment Fund. He points out that the Pennsylania Supreme Court adopted extensive excerpts from the opinion of the Common Pleas Court of Dauphin County, which it affirmed. In two of these excerpts, describing the interest of the claimants' employer, Westinghouse Electric Corporation, and the procedures for "charging" benefits, the court errs when it says:

"Its (Westinghouse's) own reserve account will be charged with the payment of any unemployment benefits that are made and its present contribution rate thereby jeopardized."

"It is, of course, apparent that where the Board orders the payment of unemployment benefits . . . to the extent of the payments pending the determination of the legal questions in the Superior Court . . . the credit balance in an employer's reserve account" (must be depleted).

If these were the facts, it would be possible to follow the Court's reasoning that "these payments having been made, the question as to whether or not the claimants-employees . . . are eligible to these benefits actually would be moot as to the payments already made when the case reaches the Superior Court."

"All of these claims or a substantial number of them, could be paid under Section 501(e) of the Act and would likely be paid before a decision on the merits has been made or could be made by the Superior Court. *There may be no justifiable issue before that Court if compensation has been paid prior to that Court's hearing and decision on the merits*' . . ." (Emphasis added.)

The case before it was a taxpayer's suit by many employers for an injunction and, following its traditional policy, the court held that any taxpayer has standing to invoke equitable relief to prevent allegedly improper payments from the tax fund. It affirmed the grant of such relief on the theory that any payment without an opportunity for prior judicial review is improper. It approved such relief not only to the claimant's employer but to a host of other employers who joined in the suit, and the injunction was issued before the referee had commenced hearings on the employer's appeal.

The fact is that no employer's "reserve account" is charged with benefit payments where the claimant is finally ruled to have been ineligible.

The total of all "balances" on individual "reserve accounts" in 1956 was $550 million. This was a wholly theoretical and fictitious figure. The amount in *the Fund* was $350 million.

As the years go by, the gap between the real Fund balance and the total of individual "reserve accounts" will widen because many benefits paid for what the legislature has deemed socially desirable reasons are not charged against any employer because the Legislature believes they are not fair measures of an employer's experience for tax-rating purposes. Payments for unemployment resulting from personal "good cause," payments to veterans for involuntary unemployment following their return from military service, payments to workers in "sick" areas and industries, *and payments after two decisions of eligibility later reversed* are examples of this.

May other employers protest?

Now Professor Wagner turns to the argument that any employer in the state may protest any benefit payment. He says that although nonchargeable benefit payments cannot affect an employer's relative experience and position on the graduated tax table, they can become a factor in the selection of the tax table applicable to all covered payrolls. The law contains several tables, and during any given year rates may be higher or lower than for the preceding year, depending on whether the year-end Fund balance had shifted as much as $50 million or $100 million. It is conceivable, therefore, that *any weekly benefit payment* might round out the sum which would invoke a higher rate table or that it might defeat realization of a lower schedule. This can be said with respect to *every payment made from the Fund and of every tax dollar payable but not actually paid into the Fund!* The Pennsylvania court did not pause to differentiate between this *possible effect* of *every* benefit payment and the *direct effect* of *charged payments* on an employer's experience rate. It did not have to do so. Is it in-

dicated that the *possible effect* of a benefit payment on the selection of rate tables gives each employer in the Commonwealth standing to *appeal* from the allowance of benefits to every other employer's employees?

There are no individual employer reserves in the Unemployment Compensation Fund. The "reserve accounts" to which reference is made in the law and in the court's opinion are merely bookkeeping accounts for gauging the relative experience of employers with compensable unemployment and benefit costs. Each employer is assigned a tax rate on a table of graduated rates in accordance with his relative experience. In various states, various methods are used for measuring such experience. Some compare charged benefits with payrolls; others compare wages against which charged benefits have been drawn with the employer's total payroll; others consider payroll declines or use a combination of methods. Pennsylvania and certain other states use the "reserve account" or "reserve ratio" method of gauging unemployment risk. The "reserve ratio" for each employer is the ratio of his total contributions (less his total *charged* benefits) to his average payroll as of a "computation date" each year. The employer's "reserve account" does not represent any individual fund, nor does it reflect anything like a definable share in the pooled, public benefit fund.

Legislative policy

The legislature adopted these provisions for the prompt payment of benefits upon the double allowance of claims by two administrative agencies in order that resort to judicial review for protection of the employer's experience rating would not prevent timely receipt of income by workers during their period of unemployment. Evidencing the need for dispatch, eligibility for unemployment compensation is determined on a weekly basis. In Pennsylvania, 85% of all benefit checks have been made available within 14 days after an eligible claim is filed. As a result of this case, an employer who chooses to take two administrative appeals will automatically postpone the payment of compensation almost four months, because benefits cannot be paid before expiration of the 40-day period for appealing to the Superior Court from the decision of the Board of Review. This delay runs far beyond the average five-week spell of unemployment. An employer who files a further appeal in the Superior Court will thereby postpone the payment of insurance far beyond the maximum duration of compensable unemployment even in duress cases.

A recent study of Pennsylvania unemployed workers revealed that of claimants whose unemployment lasted eight consecutive weeks or more, unemployment compensation benefits represented 100% of income for all single claimants. For about half of the four-person families studied, benefits represented 90% of the total income. Timeliness in the payment of unemployment insurance is a practical necessity for the effective operation of the program.

In its opinion, the Pennsylania Supreme Court said: "Although it is indisputable that the law's delays almost always cause successful litigants severe economic hardship, the answer is not to short-circuit or violate the constitution, but to expedite (by speed-up or elimination or otherwise) administrative procedures and time for appeals."

Administrative procedures can usually be speeded up, but if overdone this inevitably produces ill-considered decisions, more mistakes and more frequent resort to judicial review. As to elimination of appeal steps between the initial decision and judicial review, statistics show that during the period 1949-1955, more than 82,000 appeals were filed and heard by Pennsylvania referees, of which more than 14,000 were further appealed to the Board of Review. Obviously the referees should not be eliminated from the echelon of appeal bodies. Functioning throughout the state, they hold their hearings in the localities where the parties reside. Even if one had no compunctions against making the unemployed travel long distances to support their claims before a massive central board, Federal "fair hearing" requirements (which must be met to receive Federal monies for administration) would prohibit this.

Elimination of the Board of Review would move all secondary appeals immediately into judicial review by the Superior Court. This would reduce the period for appellate consideration of cases which would have gone to the court in any event, but it would increase the time for disposing of all other secondary appeals. With minor exceptions, courts take much longer than boards and commissions to decide cases. And what would be the reaction of the Superior Court or the Dauphin County Court to the proposal that they hear 40 to 50 compensation appeals *each week*? If, in place of each referee, a judge "learned in the law" were elected, his affirmance of the agency's allowances presumably would permit benefits to be paid at once, as the Legislature intended, because he would supply the "judicial review" the Pennsylvania Court holds essential to "due process" in these cases.

Conclusion

Professor Wagner concludes by referring to a California opinion.

"The foregoing cases demonstrates the weakness of the argument that because a commission man makes an occasional error in ordering some payment out of a public or semi-public fund, the courts must have the power to stay any and all payments during the lengthy period of judicial review. The legislature has concluded that it is wiser to have a system of unemployment compensation operating with a small percentage of error, than to have a system not operating at all. The legislative power to make such provision is unquestioned; the statutory language cannot be misunderstood; and for the courts that is the end of the matter." ☆

Nine states make changes in unemployment benefits law

Colorado unemployment changes. The Colorado Unemployment Insurance Law was recently changed providing for weekly benefit amounts ranging from $14 to $35. Effective March 18, this was changed from a range of $7 to $28. At the same time provision was made for the extension of the duration of unemployment insurance benefits from 20 weeks to 26 weeks.

The disqualification for voluntary quitting of employment, for misconduct, and for the refusal of suitable employment was changed from a range of 1 to 20 weeks to a range of 1 to 10 weeks.

Indiana unemployment changes. Effective July 6, the maximum weekly benefit amount in the State of Indiana will be raised from $30 to $33. Thus, the maximum benefits which an unemployed Indiana worker may receive will be raised from $600 to $660 during his benefit year.

Effective June 30, the Indiana dis-

qualification for voluntary leaving of employment without good cause, discharge for misconduct, and refusal of suitable work, will no longer be a definite six-week period. Under the law as amended the disqualification will continue from the date of the disqualifying act until the claimant earns, in subsequent employment, ten times his weekly benefit amount and thereafter becomes unemployed under nondisqualifying conditions.

Tennessee unemployment security changes. Effective May 1, 1957 the minimum weekly benefit payable under the Tennessee Unemployment Security Law was raised to $8. Prior to the change the minimum weekly benefit was $5.

A Tennessee worker, effective March 11, must earn total base-period wages of at least 1½ times his high quarter base-period wages in order to be eligible for unemployment benefits. Thus, work in more than one calendar quarter of a claimant's base period is required, whereas prior to the change in the law, work in only one calendar quarter was required in order that the claimant be eligible for benefits.

Nebraska raises benefits four dollars. Effective with benefit years beginning after February 23, 1957, the maximum weekly unemployment benefit payable in Nebraska was raised from $28 to $32. An unemployed worker will now be able to draw maximum benefits of $640 and not $560 as heretofore.

Effective at the same time the minimum qualifying wage provision was changed. In order to qualify for the minimum benefit of $10, a Nebraska worker must have been paid wages of at least $400 within any two calendar quarters of his base period. Before this change, only $300 was required.

Iowa employment security law changes. Employers in the State of Iowa who wish to make voluntary contributions in order that their assigned contribution rate may be reduced, must now make such voluntary contributions on or before October 31.

Employers previously had until January 31 to make such contributions.

Nevada unemployment insurance changes. Effective July 1, 1957, an unemployed Nevada worker may draw a maximum weekly benefit amount of $37.50. Before this change, the maximum weekly amount was $30. Also effective July 1, the maximum augmented weekly benefit amount (basic benefit plus dependency benefits) was raised from $50 to $57.50.

Vermont unemployment insurance changes. The Vermont Employment Security Law was recently amended to provide for a disqualification of a woman unemployed due to pregnancy for a period beginning eight weeks before the expected date of birth and extending to four weeks subsequent to the week in which the birth occurs.

Kansas employment security law amendments. The Kansas Employment Security Law was recently changed providing a maximum weekly benefit amount of $34 payable to unemployed individuals effective July 1, 1957. The maximum weekly benefit amount had been $32.

At the same time the Law was changed to provide that a claimant may receive wages of up to $8 without any loss in his weekly unemployment benefit amount. Formerly only $2 was allowed.

Missouri employment security law amendments. Effective September 1, 1957, unemployed workers in Missouri may draw a maximum weekly benefit of $33 for a duration of 26 weeks. This was changed from a weekly benefit maximum of $25 for a 24 week duration. Thus the total maximum benefits which an unemployed worker will be able to receive during his benefit year will be $858 as compared to $600 under the current law.

A pregnancy disqualification was written into the law and it becomes effective September 1. Pregnant claimants will not be eligible for unemployment benefits during a period beginning three months before the expected date of birth and continuing until four weeks after the date of birth. The disqualification for misconduct which is currently in the law (two to nine weeks) is applicable to *discharges* for misconduct. Beginning September 1, 1957, this disqualification will apply to actual discharges and also to suspensions for misconduct.

Special amendments applicable to negative-balance employers were written into the law to provide for an ultimate maximum contribution rate of 4.5%. Beginning with computations made in 1958, employers whose accounts show an excess amount of benefits charged over contributions credited, will have their contribution rates increased by 0.3% each year for a maximum of 6 years. The resulting additional 1.8% when added to the statutory 2.7% will result in a 4.5% contribution rate for employers running in the red. ☆

Indiana workers get unemployment insurance benefits during plant vacation

THE INDIANA APPELLATE COURT recently reversed a decision of the Review Board of the Indiana Employment Security Division whereby the Board held that claimants who were ineligible for paid vacations under the terms of a union contract were voluntarily unemployed and unavailable for work during the plant vacation shutdown. The claimants involved had not worked a sufficient length of time to be eligible for vacation pay during the plant vacation shutdown. The shutdown itself and the amount of seniority required for vacation pay were matters negotiated by the claimants' union and were contained in the collective bargaining agreement. Also, the claimants were informed at the time they were employed of the vacation provisions in the contract.

The vacation schedule provision appeared as follows in the contract between the employer and the union:

"3.1 Vacations shall be taken during the two-week standard vacation period except for those employees who are required by the company to work during that period due to the needs of the business. Vacations not scheduled during the standard period will be scheduled in accordance with the employee's wishes to the extent consistent with the needs of the business, giving due consideration to term of employment."

In reversing the decision of the Board of Review and ruling the claimants eligible for unemployment benefits, the Appellate Court held that neither the aforementioned provision of the union contract nor any other provision had the effect of requiring all employees to take a vacation during the vacation shut-

down, and further, that the provision was confined only to those employees who were entitled to vacation with pay. The provision did not, in the opinion of the court, render the claimants voluntarily unemployed but on the contrary forced such claimants to take an involuntary leave from work.

It would appear that in construing the vacation provisions of the union contract the Indiana Appellate Court arrived at a decision contrary to the trend which has been developed on both administrative and judicial levels in other states. The following is a quotation from J. Pfoff, who said:

"Under such facts every appellate tribunal which has passed on the question presented here has uniformly denied benefits. They hold that the vacation period is part of the contract of unemployment; is voluntarily on the part of the employee; and, therefore, the employee is not entitled to benefits. That was the holding of the Review Board in this case and it seems to me that the reasoning is based on sound principles of judicial construction." ☆

New fraud and negligence decisions

Fraud not proved by omissions; all data supplied to attorney. Taxpayer bought and sold cattle. He kept no books or records, and upon audit conceded that he failed to report large amounts of income. The court upholds the deficiencies found by the Tax Court but reverses the finding of fraud. The Tax Court's finding of fraud was based largely on the size of the understatement. All taxpayer's business was done through his bank account; he gave all the records to the attorney who prepared his return and himself initiated review of the return. The Government's case was built up from the same data the attorney had. It seems more reasonable that the understatement was due to the fact that the attorney overlooked the sizable amounts used by the taxpayer to pay off loans (an indication of income of a cash-basis taxpayer). *Eagle,* CA-5, 4/2/57.

Cash hoard story accepted in explanation of net-worth increase. The Commissioner determined deficiencies in taxpayer's income taxes for the years 1942-1949 by use of the net-worth method. His computation indicated increases in net worth over the years totaling $45,000. The court finds that taxpayer adequately established by disinterested witnesses that he had a cash hoard of $42,500 at the beginning of the period for which the Commissioner gave him no credit, and that he had no possible source of unreported income. The court therefore rejects the net-worth computation as unreliable. *Pate,* TCM 1957-59.

Deficiencies upheld in net-worth case but fraud penalties denied; no proof of source of income, use of net worth justified. During the years in issue, taxpayer derived substantial amounts of income from a variety of business activities including the renting of business property, farming, and the operation of a tobacco sales warehouse. He also assisted others for a fee in the preparation of their income tax returns. His lack of adequate records is held to justify the Commissioner's use of the net-worth method to reconstruct income. But, as there was no evidence of related source of income, the court holds the understatements of income standing alone are insufficient to show a clear intent to defraud; accordingly, some of the deficiencies were barred by the statute of limitations. *Burton,* TCM 1957-42.

Court suppressed agent's evidence; Government can't get it by grand jury examination. This court previously suppressed all evidence relating to certain accounts of taxpayer which had been obtained by a revenue agent without taxpayer's knowledge or consent. Now the court forbids the Government to call before the grand jury certain witnesses directed to bring all records of their dealing with taxpayer. The only purpose is to try to get evidence previously suppressed. *Lipshitz,* DC N. Y., 2/27/57.

Net-worth increase not due to unreported income; deficiencies barred. An operator of a jewelry store contended that substantially all of the increase in net worth as computed by the Commissioner was attributable to the receipt by him of $112,000 in cash from his father by gift or inheritance prior to and during the taxable year. Testimony of two witnesses tended to substantiate his "cash story." The court holds the Commissioner failed to meet his burden of proving fraud and finds the deficiencies barred by the statute of limitations, thereby making it unnecessary to decide any issues as to their correctness. *Papania,* TCM 1957-41.

Unreported income on fraudulent returns determined by application of Cohan rule. For the years 1938 through 1942, taxpayer did not keep any books or records. For the years 1943 through 1946, his records showed only income from a fruit-processing partnership, and those records were incomplete and inaccurate. The court holds the income tax returns for the years 1938 through 1946 were false and fraudulent and were made with the intent to evade tax. In adjusting the Commissioner's reconstruction of the partnership income, the court applies the *Cohan* rule to estimate the unreported cash or retail sales, unreported cash purchases, and compensation paid to plant and office employees. *Smith,* TCM 1957-43.

No penalty for not filing though TC had held foundation taxable in prior year. The Tax Court had found that taxpayer here was taxable for 1944, 1945 & 1946. Immediately after the decision (in 1952), taxpayer made some changes in its operations, and upon advice of counsel, did not file returns for later years. The court, having decided that it was still taxable, finds that penalty for failure to file is improper. *Gemological Institute of America, Inc.,* DC Cal., 2/20/57.

Nunan conviction affirmed [*Certiorari denied*]. The Second Circuit, in a long review of the evidence and objections to trial procedure, affirmed the conviction of this former Commissioner of Internal Revenue. It placed great emphasis on taxpayer's lack of records, his extensive cash transactions and the fact that he prepared his own returns, listing round amounts with little or no identification. *Nunan, cert. den.,* 3/25/57.

Attorney-accountant guilty in failure to file. The jury below found taxpayer guilty of willful failure to file an income tax return. This court finds the instructions on willfulness proper and upholds the verdict. Taxpayer argued that failure was due to oversight because of pressure of work. *Haskell,* CA-10, 2/18/57.

CORPORATE & PERSONAL PROBLEMS IN

Taxation of compensation

EDITED BY JOHN P. ALLISON, LL.B.

Jenkins Bill aims to ease prohibited-transactions rule for employees' trusts

by **H. OBER HESS**

Ever since the Commissioner ruled that an employee's trust can acquire its employer's stock but not its debentures, tax men have dissented vigorously. The Jenkins Bill, now before Congress, attempts to meet their objections. The author, a partner in the Philadelphia law firm of Ballard, Spahr, Andrews & Ingersoll, here reviews the bill, the arguments of tax men, and other recent developments.

THE 1954 CODE made only two significant changes in the law affecting employees' trusts. One applied to exempt employees' trusts the "unrelated business income" provisions; the other applied the "prohibited transactions" provisions of Section 503(c). That section, the one we will discuss here, states that it is a prohibited transaction for the exempt employees' trust:

1. to lend any part of its assets to the employer "without the receipt of adequate security and a reasonable rate of interest";

2. to pay unreasonable compensation to the employer for services rendered;

3. to make any part of its services available to the employer on a preferential basis;

4. to make a purchase of any property from the employer for an excessive consideration;

5. to sell any substantial part of its assets to the employer for an inadequate price; and

6. to engage in any other transaction which results in a substantial diversion of its property to the employer.

Of these six types of prohibited transactions only Nos. 1 and 4 are particularly significant for employees' trusts.

No. 4 prohibits an exempt employees' trust from making any substantial purchase of securities or any other property "for more than adequate consideration in money or money's worth" from the employer. In the purchase of securities from the employer, the only aspect which places the transaction in jeopardy is the consideration. It will not matter if the securities were issued by the employer itself unless, of course, they are debt securities rather than equity securities, in which event they come within the prohibition of No. 1.

Loans to employer

As to No. 1, loans from the employees' trust to the employer are not per se prohibited so long as there is adequate security and a reasonable rate of interest. The only requirement for an equity security is that the price be reasonable; it can be issued by the employer and be completely unsecured. However, when indebtedness is involved, the price paid by the employees' trust for the employer's indebtedness may be entirely reasonable, but the transaction is still prohibited unless there is adequate security and a reasonable rate of interest.

What is adequate security

The proposed Regulations which have been pending since January 21, 1956 (see Section 1.503(c)-1) say that adequate security "means something in addition to and supporting a promise to pay, which is so pledged to the organization [in this instance the employees' trust] that it may be sold, foreclosed upon or otherwise disposed of in default of repayment of the loan, the value and liquidity of which security is such that it may reasonably be anticipated that loss of principal or interest will not result from the loan. Mortgages or liens on property, accommodation endorsements of those financially capable of meeting the indebtedness, and stock or securities issued by corporations other than the borrower may constitute security for a loan to the persons or organizations described in Section 503(c). Stock of a borrowing corporation and unsecured debentures of a borrower do not constitute adequate security under that section."

Thus, neither the statute nor the proposed Regulations exclude debentures from the scope of prohibited transactions, even though the employees' trust purchases them on the open market at the same price and subject to all the market conditions which influence purchasers generally. The difference in treatment as between common stock and debentures in precisely this regard has led to a great deal of criticism of the Treasury's position under the 1954 Code, and the matter was the subject of considerable testimony taken last November before the Subcommittee on Internal Revenue Taxation of the House Ways and Means Committee (the Mills Committee). Prior to these hearings, the Commissioner had taken the position in Technical Information Release 27 (November 8, 1956) that the acquisition of any employer indebtedness by an employees' trust after March 15, 1956 would be regarded as a prohibited transaction, as well as an acquisition prior to that date, if held after January 31, 1957.

Following the agitation which found expression in the testimony before the Mills Committee last November, the Commissioner issued Technical Information Release 35 (January 2, 1957), in which Technical Information Release 27 was reaffirmed as to *indebtedness other than debentures.* However, as to *debentures,* the new release provided that their acquisition should be regarded as prohibited only if the debentures were purchased after November 8, 1956 or, as to debentures purchased prior to that date, only if they were held after June 30, 1957.

Thus, at the present time, any loan to the employer, *other than a debenture* by the employees' trust, is a prohibited transaction. Second, the acquisition after November 8, 1956 of any debenture is also presently a prohibited transaction. Third, the acquisition of any debenture prior to that date will become a prohibited transaction unless the debenture

is disposed of before June 30, 1957. These generalizations are subject to this qualification, however. In Section 503(a)-(1) it is provided that the 1954 Code provisions which place exempt employees' trusts under the prohibited-transactions features of the law apply to an employees' trust *only* "if it has engaged in a prohibited transaction after March 1, 1954." This has been interpreted in the proposed Regulations (Section 1.503(c)-1(b)) to mean that any employer indebtedness which was held by an employees' trust prior to March 1, 1954 may be continued outstanding until maturity and not run afoul of the new law.

What is adequate interest

The proposed Regulations set down no general rules on adequate rate of interest. In one of the illustrations appearing in Section 1.503(c)-1, it is supposed that the obligation bears 3% interest at a time when "the prevailing rate of interest charged by financial institutions in the community where the transaction takes place is 5% for a loan of the same duration and similarly secured." This differential is regarded as making the 3% interest rate unreasonable. The difficulty is that the prevailing rate of interest is rarely ever so precisely established as the Regulations assume in any given community at any given time, particularly when the money market is so directly affected by the monetary policy of the Federal Reserve Board.

Notice of prohibited transaction

The penalty for engaging in prohibited transactions is loss by the employees' trust of its tax-exempt status. *But* the penalty is not automatic, nor is it immediate. Under Section 503(a)(2) of the 1954 Code it is said that an employees' trust shall be denied exemption by reason of prohibited transactions "only for taxable years after the taxable year during which it is notified by the Secretary or his delegate that it has engaged in a prohibited transaction, unless such organization entered into such prohibited transaction with the purpose of diverting corpus or income of the organization from its exempt purposes, and such transaction involved a substantial part of the corpus or income of such organization."

This statutory language is quite clear, except perhaps the words which refer to a prohibited transaction engaged in "with the purpose of diverting corpus or income of the organization from its exempt purposes."

Except in cases where the purpose is bad, loss of exemption cannot come until the taxable year following that in which the Secretary gives notice. This will normally allow an ample time for correction. Furthermore, the Secretary's notice cannot be in the form of a general Ruling or publicity release which each employees' trust must, at its peril, interpret correctly and apply to itself. The proposed Regulations Section 1.503(a)-1) say that the exempt trust loses its exemption "for any taxable year subsequent to the taxable year in which there is mailed to it a notice in writing by the Commissioner that it has engaged in such prohibited transaction. Such notification by the Commissioner shall be by registered or certified mail to the last known address of the organization."

It would appear that we need not worry too much about the exception for the improper purpose. The use of the word "purpose" seems quite clearly to imply that there must be a bad motive on the part of the exempt trust. As long as there is a good case to be made to refute an allegation of improper purpose, it would seem there is no real risk of losing the exemption except after the notice from the Commissioner.

Any appreciable hazard is further removed from the situation by Revenue Procedure Ruling 57-5 which was issued early in February, 1957. In the first place, this Ruling specifically recognizes that ". . . exemption is denied only for taxable years after the taxable year during which the Commissioner issues a notice by registered or certified mail . . ."

The Ruling also says that before the notice is issued the exempt trust in question will be given an opportunity to have a hearing in the usual case. If it is too late in the year to have a conference in advance of issuing the notice, provision is made for the trust to request a conference after its receipt.

Despite the prohibited-transactions provisions, investments of an employees' trust must still meet the test of Section 401(a) which carries forward the language found in Section 165(a) to the effect that an exempt trust must be operated exclusively for the benefit of employees. In the past, of course, it was not too difficult to satisfy the Service on this point if the employer's credit was any good at all. Seldom did one find a case as clearly violative of the exclusive-benefit requirement as *Time Oil Co.*

As already indicated, the Mills Committee hearings developed considerable dissatisfaction with the prohibited-transactions features of the 1954 Code dealing with exempt employee trusts, particularly on the subject of debentures. Since the hearings were held Congressman Jenkins introduced H.R. 697. This bill attacks the problem by suggesting a rephrasing of Section 503(c)(1) of the 1954 Code by making it a prohibited transaction to lend "any part of its income or corpus, without the receipt of adequate security or approval of an independent banking trustee based upon the credit standing of the obligor, and a reasonable rate of interest."

This is precisely the same language now found in the Code, except that approval of an independent banking trustee of the loan in question is a complete exoneration. This bill or something similar to it would seem to deserve support. It would seem illogical and inconsistent to permit investment in the employer's common stock and prohibit investment in the employer's debentures, particularly when they are traded and the market price represents the assessment by the business community of the adequacy of the credit behind the debenture, whether secured or not, and the reasonableness of the rate of interest. Moreover, it is hard to see how in the case of employees' trusts the prohibited transactions provisions are needed at all inasmuch as the exclusive-benefit test, applied to all the transactions of the trust, furnishes a potent sanction which is not present in the case of other forms of exempt organizations for which the prohibited transactions provisions were introduced by the Revenue Act of 1950.

Few benefit plans disqualified currently

APPARENTLY TAX MEN setting up pension and profit-sharing plans are getting to know their business pretty well, for in the last three months of 1956 only 15 out of 1496 plans were disqualified by the IRS. Figures on this activity are interesting:

	Profit Sharing	Pension	Stock Bonus
Initial qualifications			
approved	635	861	2
disapproved	8	7	..
Terminations	30	52	
Closed without issuance of determination letter	25	29	

Could Casale have won if he had done it slightly differently?

IN DECEMBER, Robert J. Lawthers commented at some length on the *Casale* case (26 TC No. 131). He felt that the Tax Court had correctly decided the case, which involved a corporation's right to deduct a premium on a life-insurance policy funding the company's retirement agreement with its controlling stockholder. The corporation, which had taken out a combined life-annuity contract to mature at 65, was declared to be the owner of the policy, but the officer, by agreement with the corporation, was given the right to designate the beneficiaries in the event of his death. The court held that the officer's rights under the retirement agreement were nonforfeitable and that the annual premium of $6,000 paid by the corporation represented a distribution equivalent to a taxable dividend.

G. F. Byrne, a San Anselmo, California public accountant, wrote us that he felt there might have been another way out for Casale. He said:

Mr. Byrne's view

I agree only in part with the article by Robert J. Lawthers on the *Casale* case. Why get so excited about a Tax Court case when you have a stronger case in *Paramount Richard Theatres, Inc.*, 135 F2d 602?

Why not deal at arm's-length at all times when dealing with an officer stockholder? Does not the board of directors of the corporation have the right to say how insurance proceeds are to be spent when received upon the death of the officer-stockholder?

Why not be more careful, thoughtful and prudent when drawing the original contract or agreement for retirement with your officer-stockholder? Don't give the officer-stockholder the right to say who is to receive his retirement salary when he dies; stop at the wife.

Mr. Lawthers' reply

We sent Mr. Byrne's letter to Mr. Lawthers who replied:

I think the *Casale* case is something to get excited about for two reasons. It gives what I believe to be a needed emphasis to the fact that the courts will cut through sham transactions between a stockholder and his corporation—and properly so. This may seem such old hat that it is not worth getting excited about, but excitement is certainly warranted when the court, in understandable indignation at the sham, taxes the wrong thing at the wrong time.

Paramount-Richards is an important case, but the facts are so different that it is of little value in Mr. Casale's situation except as showing that distributed earnings may constitute a dividend even though the transaction does not look like a dividend distribution and none of the customary formal requirements for such a distribution are met. An even more important case from this viewpoint, and a beautifully reasoned one, is *Golden v. Commissioner*, (113 F2d 590, 3d Cir. 1940). In neither of these, however, was the issue otherwise similar to that of *Casale*.

I agree on the desirability of arm's-length dealings between an employed stockholder and his corporation. When, however, the employee is a 98% stockholder, looking into the mirror as he negotiates with himself, as the corporation, in a transaction designed to benefit himself, it may be difficult to make the arm very long.

I think that what the second paragraph of Mr. Byrne's letter refers to is the possibility that the transaction could have been entirely different. If there had been no agreement between Mr. Casale and his corporation, but insurance had been taken out solely to indemnify the corporation for his loss as a key man, then I am confident there would have been no *Casale* case and no income tax problem either in connection with the payment of the premiums or receipt of the proceeds by the corporation at death. However, I am not so sure that if this had been done the directors of the corporation could have distributed those proceeds to Mrs. Casale free from any possible danger of income tax liability. Directors can distribute corporate assets for corporate purposes, but when they decide on such a distribution the Commissioner and the courts may be expected to look for income tax liability to the distributee.

Under the general circumstances of the *Casale* case, I do not feel that Mr. Casale would have been any better off, from the income tax viewpoint, if his agreement had purported to deny him the right to say who should receive the benefits when he died. Could it be effectively denied that if the wife had been named in the agreement and it had stopped there the provision for the wife would have been just as much a use of the corporation for Mr. Casale's benefit as under the agreement as drawn?

Life insurance can serve many valuable purposes for individuals, corporations and other businesses. When insurance on the life of an employed stockholder is to be carried by, and be for the benefit of, the corporation, it is only natural that the insured should secondarily give some consideration to the benefits he will indirectly derive through the benefiting of the corporation. If, however, the primary objective is the personal benefiting of the stockholder, insurance carried by the corporation is not indicated. When such a situation becomes flagrant enough, the only problem for the Commissioner and the courts is going to be whether to tax as a dividend each premium as paid, or to wait until death when proceeds have been distributed. My argument with the Tax Court is that in *Casale* it made the wrong choice. ☆

Should you change your pension plan to reflect recent OASI changes?

BECAUSE OF THE social security amendments passed by Congress in 1956, many companies will have to reconsider whether they will want to change their retirement benefit planning. Edwin Shields Hewitt and Associates brought out the significance of the changes for the pension planners faced with coordinating private plans with the revised Government program. As reported in *For Your Information*, the reduction of the age—from 65 to 62—at which working women can qualify for social security benefits will put pressure on private programs to include similar early retirement provisions. This reduction will also necessitate a change in the social security adjustment options provided in some private plans.

Management will have to take a new

look at private disability payments in the light of the Social Security Administration's entry into this field. The social security definition of permanent and total disability may influence or supersede the definitions used in private plans.

Employers without any disability benefits in their retirement plans will now be under pressure to include them.

Many pension plans have disability provisions based on the assumption that social security benefits are not payable before age 65. In reconsidering these provisions, companies will have to decide whether to reduce their benefits formula, eliminate disability benefits, or continue current disability benefits in addition to those under social security.

Unions can be expected to intensify their drive to divorce negotiated plans from social security wherever possible, even though the repeated increases in Government benefits for lower-paid workers would seem to justify companies in compensating for social security in their own benefit plans.

Since further changes in social security seem probable, companies would be wise to make their retirement plans flexible enough to accommodate revisions as they come along. One example of this foresight is found in General Motors' plan for its hourly employees, under which disability benefits are to be adjusted at "age 65 or, if earlier, the age at which the disability pensioner becomes eligible for a Primary Insurance Benefit. . . . " Another example is the type of plan which provides for a specified percentage of compensation, including all or part of social security payments; if Government benefits increase, the amount provided by the private pension is reduced.

The increase in social security contribution rate poses another problem for management. The amounts set aside for private pensions may have to be reduced to prevent the combined cost of public and private benefits from becoming prohibitive. As social security increases its coverage and its benefit levels, there will be less incentive to meet needs through private programs.

Current emphasis on coordinating private and government benefits has created pressure for the standardization of private plans so that a universal security package could be established. But this disregards the need for a variety of private plans to fit different areas of our economy. As social security continues to grow in scope, private benefit planning should become increasingly concerned with tailoring programs to meet the specific needs of particular groups. The wise course would seem to be to build into private plans such flexibility as will prevent the employer being forced out on a limb by future OASI changes. ☆

New compensation decisions this month

No capital gain on lump-sum pension distribution; minor unpaid services were employment. Capital gain treatment of lump-sum distributions from a qualified employees' plan is available only upon a complete termination of the employment relationship. Therefore the Service rules that an employee who continues to act in the capacity of an officer and director for minor services, even though he is uncompensated, is employed, and the distribution he receives is taxable as ordinary income. *Rev. Rul.* 57-115.

Reimbursement to contractor for pension cost deductible as business expense. Payments made by a taxpayer-shipowner to an independent stevedoring contractor to reimburse him for the costs of a union-negotiated qualified pension plan for longshoremen employees of the contractor are deductible by the taxpayer as ordinary and necessary business expenses. The contractor is required to include the payments in gross income but is entitled to a deduction for contributions actually made to the plan within the applicable limits of Section 404(a). *Rev. Rul.* 57-104.

Guides issued for qualification of employee trusts. The Service has codified its prior releases and has set forth detailed rules and guides with respect to the qualification of stock bonus, pension, profit-sharing, and annuity plans under the 1954 Code. *Rev. Rul.* 57-163.

Form 990-P for employees' insurance trusts. Trustees of exempt employees' trusts which hold insurance policies on contract need fill out the information only on the first page of Form 990-P provided a copy of a notification from the employer that he has furnished the information required of him by the regulations is attached. In all other cases the Trustee must fill out the schedules on pages two and three of the form giving information respecting the investments in the insurance contracts. *Rev. Proc.* 57-15.

Pensions of disabled employees excludable under recent Haynes case. Payments received by a retired employee as a result of permanent and total disability under a company retirement and death benefit plan to which the employee made no contributions are held to be excludable from gross income as amounts "received through accident or health insurance" in the light of the recent Supreme Court decision in the *Haynes* case. *Jackson,* 28 TC No. 6. Similarly retirement pay received by a state employee, for incapacity not arising from his work, under a retirement law providing for such payments after 10 years of service, are excludible as "accident or health insurance" payments. *Sibole,* 28 TC No. 7.

State official receiving fixed salary entitled to "sick pay" exclusion. An elected State of Arizona official whose salary is fixed by law may exclude as sick pay under section 105(d) wages received while he was absent from work on account of sickness. *Rev. Rul.* 57-152.

Reynolds' employee profit-sharing not deductible. Under a plan begun in 1912 and designed to encourage selected employees to invest in the stock of the company, the Reynolds Tobacco Company distributed part of its annual profits to officers and other employees in proportion to the stock they owned. The court disallows any deduction for the years 1940-48 since the distributions were not purely for services and were not measured by the value of the services. The corporation had regarded these payments as dividends, before and during the years in question, when it computed the base for the excess profits tax the undistributed profits tax and social security and withholding tax. It also considered them as dividends under the wage-stabilization laws, in SEC reports, and in state income tax returns. The court notes that a partial deduction was allowed by the Tax Court (TCM 1956-161) for the year 1949 but a new bylaw in that year considerably changed the plan. *Reynolds Tobacco Co.,* Ct. Cls., 4/3/57.

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Sick pay from employer's self-insured plan not taxable (old law). In 1949 taxpayer received sick pay from the Southern Bell Telephone Co.'s company plan which had been in effect for many years. Section 22(b)(5) of the 1939 Code granted an exclusion under "accident or health insurance." The Government contended that the Southern Bell Co.'s plan was not "health insurance" but a "wage continuation" plan. The Supreme Court holds that the plan comes within the meaning of health insurance. The statute did not specify commercial insurance. [Under the 1954 Code the sick pay exclusion Sec. 105 is specifically applicable to wage continuation plans. *Ed.*] *Haynes,* Sp. Ct., 4/1/57.

Legal fees not long-term compensation; prior year payments not gifts. A lawyer who received $5,700 in 1952 for legal services in connection with a will-trust litigation over an extended period is held not entitled to treat the receipt as long-term compensation because it was less than 80% of $8,300, the total compensation received. His contention that $2,600 received in prior years was a gift and not compensation was overruled by the evidence. Furthermore, the fact that the prior payments were made from trust income while the 1952 payment was from trust corpus is immaterial. *Bush,* TCM 1957-57.

Work period for patent under 36 months; long-term income relief denied. Taxpayer developed a process for curing Mexican beef. He first conceived the idea for the process on 6/24/47 and filed application for a Mexican patent on 9/19/49. On 6/25/51 he executed a power of attorney to a Mexican patent law firm to prosecute the original patent application on his behalf. The patent was granted on 7/23/51. The court holds taxpayer fully completed work on the process in 1949 when the patent application was filed. He therefore did not fulfill the 36-month work-period requirement of Section 107 (b) (1939 Code) for prorating the income received from the patents over prior years. *Morgan,* TCM 1957-60.

Tax Court insists on valuing option stock at public quotations despite restrictions. Taxpayer's employer gave him the option to purchase company stock at a price substantially less than market, but it restricted his right of resale of the stock. The Tax Court held (23 TC 227) that the option was compensatory and that taxpayer had income upon exercise in the difference between option price and market value on the New York Stock Exchange. The Seventh Circuit agreed that the transaction was compensatory, but it disagreed with the Tax Court's finding that the difference between the option price and market value was the proper measure of the compensation. On remand, the Tax Court now says it is unable to find any proper method of computation other than the one used in its original finding, and denies the Commissioner's motion for a new hearing. *MacDonald,* Docket No. 46330.

Social Security pension based on accrual basis returns filed; didn't show cash basis proper. After the Social Security Administration fixed taxpayer's pension in accordance with his accrual basis returns for his grocery store he filed amended returns on a cash basis showing higher net income in each year. The Social Security Administration refused to increase his benefits. The court says merely that taxpayer failed to prove he was on a cash basis. *Di Bianco,* DC N. Y., 3/13/57.

Special fee to employee for supervising construction separable; was long-term compensation. During the period 1947 through 1951, taxpayer was president and general manager of Amalgamated, a large cooperative housing project, and of Consumers, a separate cooperative operating a retail grocery. His duties involved general executive supervision of both organizations. In 1948, Consumers was engaged by Amalgamated pursuant to a contract, which was approved by the State Commissioner of Housing, to construct an extension to the housing project at a cost of $8,000,000. Taxpayer, who was thoroughly experienced in construction work, actually performed the work of a general contractor for which in 1951 he was paid by Consumers a special fee of $25,000. Taxpayer's services in supervising the construction of the extension, and the $25,000 compensation therefor, is held separate, distinct, and severable from his regular duties and compensation as president of Consumer. He was therefore entitled to treat the fee as "long-term compensation" for services extending over a period of 36 months or more within the meaning of 1939 Code Section 107(a). *Kazan,* TCM 1957-44.

THE TAXATION OF INDIVIDUALS

Personal tax problems

EDITED BY BENJAMIN HARROW, J.D., CPA

The alimony trust: when and how to use this valuable but hazardous (taxwise) device

AN ALIMONY TRUST is frequently the most practical answer to support and property division problems that arise in divorce situations. Yet this device brings with it many complications. Is there a gift tax on its creation, on the wife's interest, or on the children's interest? Is there a capital gain tax on appreciated property? Is there an estate tax when the donor dies? What is the basis of the property put in the trust?

James B. Lewis, an attorney with the New York law firm of Paul, Weiss, Rifkind, Wharton and Garrison included analysis of these questions when he addressed the recent American Bar Association annual meeting. We have asked him to let us extract from his larger discussion those passages affecting taxation of such trusts, and present them here. Readers interested in the non-tax aspects of this discussion will find the complete text of the paper in Trusts and Estates, October, 1956. Mr. Lewis is, incidentally, a frequent writer and speaker on taxation, and author of the PLI monograph *The Estate Tax*.

Types of settlements

A husband may satisfy his obligation to support his wife after divorce or separation by one of three principal methods: 1) periodic payment of alimony directly to her; (2) transfer directly to her of a lump sum of money or property; or (3) creation of a trust for her support. He may also satisfy his wife's claims to a property settlement in recognition of dower or other marital property rights by either the second or the third method.

The choice of method will vary with the facts of the particular case. Various factors may favor or require provision for direct alimony payments. The husband may be financially unable to make an adequate property settlement. He may have large business or professional income, so that the cost of alimony may be small after allowing for its deduction from his gross income. The wife may wish to participate, at least in part, in anticipated increases in the husband's earnings. The husband's property, although valuable, may be non-income-producing and difficult to sell, thus making a property settlement unsuitable.

In other cases, a lump-sum property settlement may be best. Such a settlement frees the husband from continuing claims by his wife—and it insulates the wife from fluctuations in the husband's financial fortunes. A property settlement, unlike alimony, may provide for the wife after the husband's death or incapacity, or after her own remarriage. The husband may have large property but relatively little ordinary income, so that an alimony deduction would be of little value to him. For instance, his property may include a substantial volume of tax-exempt securities, or of low-dividend stocks or other property held for capital appreciation.

To those who can afford its initial cost, the third method—the alimony trust—may appear the most sensible choice. Continued support of the wife is better assured under an alimony trust than under a direct settlement. The judgment of an independent trustee is substituted for the often more unstable judgment of the wife. The trust provides greater protection against the fortune hunter. The alimony trust permits provision for the wife to be combined with provision for the children, either as income beneficiaries or as remaindermen. Flexibility may be introduced by empowering the trustee to invade principal where necessary or to vary distributions among the children to meet their respective needs.

The alimony trust poses distinctive tax problems for which simple answers cannot be found. By reason of the alimony trust, the settlor at one time or another may be called upon to pay a capital gain tax, an income tax, a gift tax and an estate tax. The husband who makes a direct lump-sum settlement will escape the income tax and the estate tax. The husband who pays his alimony through periodic payments will not be subject to the capital gain tax. The factors which determine whether the various taxes are owing are not at all uniform. In fact, there is little correlation among the income, estate and gift taxes as applied to alimony trusts.

TAXES ON CREATION OF TRUST

Gratuitous transfers are subject to the gift tax and, if the transferor made the transfer in contemplation of his death or if he retains certain contacts with the transferred property, the transfer is also subject to estate tax at his death. The gift of property which has appreciated in value is not subject to a capital gain tax. On the other hand, where property is transferred for an adequate consideration, the transfer is subject neither to gift tax nor to estate tax, but if the transfer is of appreciated property, a capital gain tax is payable.

Much confusion has arisen in the application of these principles to property settlements in connection with divorce or separation. The husband's transfer to the wife in satisfaction of his familial obligations of support and dower is, of course, not gratuitous. Nevertheless, as we shall see, the gift, estate and capital gain tax consequences of such a transfer have not been easy for the courts to establish.

The alimony trust presents an even more complex problem. Ordinarily, the remainder of such a trust is to pass to the children. Transfers by parents of property to their children (other than

[1] Proposed Reg. (§25.2512-8.
[2] 340 U.S. 106 (1950).
[3] See McMurry v. Comm., 203 F2d 659 (1st Cir. 1953); Rosenthal v. Comm., 205 F2d 505 (2d Cir. 1953); Bank of N. Y. v. United States, 115 F. Supp. 375 (S.D. N.Y. 1953); Estate of Chester H. Bowers, 23 TC 911 (1955).
[4] Krause v. Yoke, 89 F. Supp. 91 (D.W. Va. 1950) (prior trust established in satisfaction of right to support; subsequent trust in satisfaction of dower held a gift). Cf. Comm. v. Barnard's Estate, 176 F.2d 233 (2d Cir. 1949) (transfer in satisfaction of courtesy); Clarissa H. Thomson v. Comm., 6 TCM 822 (1947) (same). One court has rejected *ET* 19. Edward B. McClean, 11 TC

current expenditures by a parent in satisfaction of his legal obligation to support a minor child) are subject to gift tax and, where made in contemplation of death or where certain contacts are retained, to estate tax. The problem is complicated by the difficulty of determining whose bounty the children are enjoying. Nominally at least, the transferor is the husband. However, the wife may have induced the transfer by parting with a portion of her rights to support and dower, so that she is the children's benefactor. Since the wife's rights are not easily susceptible of measurement in dollars, the question of which spouse was the economic source of the transfer may be a vexing one.

Gift tax

A taxable gift is a transfer for less than an adequate and full consideration. A "sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's-length, and free from any donative intent), will be considered as made for an adequate and full consideration."[1]

Transfers to spouse

Presumably, whether a transfer is a taxable gift should in all cases turn upon the adequacy or inadequacy of the consideration. In 1950, however, the Supreme Court in the *Harris* case ruled that a transfer to a spouse effected by a court decree did not have to be supported by adequate consideration in order to escape gift tax[2]

In the *Harris* case, the marital settlement was not to become operative until the entry of the decree of divorce. The Supreme Court held that the transfer was nontaxable because it was effected by a decree of court. This latter fact was, in the opinion of the court, enough to exempt the transfer from the consideration requirement. Subsequent cases interpreting *Harris* have stressed that mere approval of the settlement by the divorce decree does not make the transfer one effected by the court.[3] The transfer must be made conditional upon the approval of the court, or, if the agreement has independent vitality, the court which gives its approval must have had the power to prescribe a different property settlement.

Section 2516 of the 1954 Code broadens the *Harris* exemption in some respects. It eliminates the necessity of approval by a divorce court, but imposes conditions of its own. The section provides that a transfer settling the marital rights of the spouse or providing a reasonable allowance for the support of children during minority will be deemed a transfer for "full and adequate consideration," if the agreement pursuant to which the transfer was made was entered into within two years prior to a divorce. It must be noted that the section is applicable only if the parties do obtain a divorce.

Cases not exempted from gift tax by Section 2516 are presumably to be governed by the rules developed by the courts and the Treasury under prior law. The Harris principle should continue to protect the transfer from gift tax where it is effected by a decree of separation or decree for support. Where neither Section 2516 nor the Harris doctrine shields the transfer, its liability to gift tax should turn upon whether the right released by the transferee constitutes consideration within the meaning of the gift tax law. The position of the Treasury Department on this question is stated in the now famous ET 19, issued in 1946. The release of dower, or its statutory equivalent, is not consideration. The release of the right to support does constitute consideration. A transfer made in satisfaction of both the right to support and dower is a gift to the extent allocable to the latter. *ET* 19 prescribes a method of allocation for cases of mixed consideration.

ET 19 has not been received with unquestioned acceptance by the courts. In general, a transfer made in consideration of the release of dower alone has been held to be a gift.[4] But if the transfer was made in consideration for the release of both the right to support and dower, the courts have refused to find a gift in the absence of a clearly supportable allocation.[5] If the Commissioner fails to show that the amount transferred is in excess of the reasonable value of the right to support, the whole transfer will escape gift tax. Because of the difficulty in fixing the value of the right to support, a clear allocation is not easily made. As a result, imposition of gift tax on marital settlements is likely only in those cases in which the transfer is solely in consideration for the release of dower, or where it is clearly in excess of the value of the right to support.

Transfers to children

Expenditures by a parent in discharge of his duty to support his children during their minority are not taxable gifts. On the other hand, payments to children for their support after they have attained majority are taxable gifts, even if effected by decree of court.[6] Transfers to children other than for their support are, of course, taxable gifts whenever made.

Accordingly, it would seem that the designation of the children as remaindermen of the alimony trust constitutes a taxable gift. For not only is the conveyance of the remainder generally in addition to a provision for the support of the children during their minority, but the remainder does not have to become possessory before attainment of majority. The cases indicate that taxpayers generally have voluntarily treated the designation of children, as remaindermen as taxable gift.[7] Some, however, have apparently treated the transfer of the remainder to the children as an integral part of the settlement with the wife, and, on that account, have paid no gift tax.[8] The one time that the Commissioner disputed this position, he lost. In *John R. Geary*, the Tax Court held that the transfer of the remainder to the children was part of the consideration paid to the wife for the release of her rights, and hence was not taxable to the husband as a gift.[9] In so holding, the Tax Court noted that the wife wanted the remainder to go to the children. It also noted the futility of attempting to ascertain which spouse was primarily responsible for the designation of the children as remaindermen.

The logic of *Geary*, in exempting the husband from a gift tax on the transfer of the remainder of the alimony trust to the children, should result in taxation of the wife upon that remainder. For clearly, the children are third-party beneficiaries of the agreement between the spouses. If the husband is not their benefactor, then the wife must be. Research reveals, however, no case in which the Commissioner has tested the possibility of obtaining a gift tax from the wife.

In the event that one of the spouses

543 (1948) (alternate holding).
[5] Junius P. Judson, 6 TCM 242 (1947).
[6] See Rosenthal v. Comm., supra, note 3; Comm. v. Greene, 119 F2d 283 (9th Cir. 1941), *cert. denied*, 314 U.S. 641.
[7] See e.g., McMurtry v. Comm., supra note 3; Edward B. McClean, supra note 4; Hooker v. Comm., 174 F2d 863 (5th Cir. 1939).
[8] In Edna W. Gardner Trust, 20 TC 885 (1953), an income tax case dealing with basis of property to an alimony trust, the Commissioner did not even argue that the transfer of the remainder to persons other than the wife should be considered a gift.
[9] 2 TCM 202 (1943).

is held to have made a taxable gift, the provisions of the Code dealing with gifts by married persons assumes significance.

Section 2523 allows a donor who transfers an interest in property to a donee who at the time of the transfer is the donor's spouse, to deduct an amount equal to one-half of the value of the interest in computing his taxable gifts for the year. A transfer in trust qualifies for this so-called "marital deduction," however, only if the donee-spouse has the power to appoint the remainder to himself or to his estate, or if the remainder passes to his estate. Thus, the marital deduction, although applicable to outright property settlements with the wife effected before the termination of the marriage, will in the common situations be inapplicable to the alimony trust.

Section 2513 offers more promise to the donor in a marital settlement. This section provides that a "gift made by one spouse to any person other than his spouse shall . . . be considered as made one-half by him and one-half by his spouse." This gift-splitting provision allows the donor to obtain a lower tax rate on a gift, to double the number of the $3,000 per donee exclusions, and to use two $30,000 lifetime exemptions. To obtain this favorable treatment, each spouse must sign a consent (on the gift tax return of the other) to treat all gifts made during the calendar year by either while married to the other as gifts made one-half by each, and must also execute (after the close of the taxable year) a gift tax return reporting one-half of the "split" gifts.

Marital deduction and gift splitting

The marital deduction and gift-spitting provisions apply to gifts made at a time when the donor was still married to his spouse. Thus, gifts completed prior to divorce clearly qualify. Some questions will arise, however, about gifts effected by the divorce decree. The Commissioner has yet to intimate whether these gifts qualify.

Securing the consent of the donee-spouse to gift-splitting may be difficult. The consent must be signified at a time after the close of the calendar year in which the gift was made. Securing a power of attorney from the wife to file such a consent is probably insufficient. Perhaps the best that can be done is to obtain a contractual promise from the wife that she will execute the consent and file the necessary gift tax return after the close of the calendar year in which the gift was made.

Estate tax

Sections 2036 to 2038, inclusive, of the 1954 Code bring into the transferor's gross estate various "incomplete" inter vivos transfers. Section 2036 strikes at transfers in which the transferor has retained a life estate. Section 2037 deals with transfers that take effect in possession or enjoyment at or after the death of the transferor and in which he retained at least a 5% reversionary interest. Section 2038 covers transfers subject to the transferor's power to alter, amend, revoke or terminate.

Sections 2036 to 2038, inclusive, do not apply to transfers made for "an adequate and full consideration in money or money's worth." Moreover, if the consideration is less than adequate and full, only the excess of the fair market value of the property at the time of death over the value of the consideration received is included. The Code provides expressly that relinquishment of dower or curtesy, or their statutory equivalent, does not constitute consideration for the purposes of the transfer sections. Relinquishment of the right to support does qualify as consideration. Thus, if both the right to support and dower are relinquished in consideration for the transfer, only the portion of the trust allocable to the former will be treated as a transfer for consideration. Furthermore, in the event that release of the right to support is the only consideration for the transfer, it is made for a full and adequate consideration. Of course, if the wife's release of support rights supports only the life estate given to her, the remainder to the children will not be a transfer for full and adequate consideration. There are no decisions as to whether the *Harris* principle permits transfers otherwise subject to estate tax to escape the consideration requirement.

Theoretically at least, Section 2036 may be broad enough to require inclusion of the alimony trust in the estate of the husband. A settlor has been held to have a life estate in a trust the income of which is provided for the support of his wife.[10] Since the payment of the income discharges the husband's legal obligation of support, he has "retained the enjoyment of the income of the trust." Nevertheless, in practice alimony trusts do not appear to have been included in the husband's gross estate—and a subtle paradox would inhere in such inclusion. For the husband is regarded as retaining the enjoyment of the trust because he uses it for the satisfaction of the continuing right to support. Yet the release of the right to support constitutes consideration for the purpose of the estate tax. It is only because the wife releases a right to dower, or a remainder passes gratuitously to the children — factors in themselves not enough to render the trust vulnerable to Section 2036 — that the test of a "full and adequate consideration" is not met.

In the event that the court does not retain jurisdiction over alimony after the divorce, there is an additional ground for arguing that the alimony trust cannot fall within Section 2036. For in such a case the right to support is completely discharged at the moment of divorce. The alimony trust then becomes comparable to the direct lump-sum payment, in that once the trust is created the husband's obligation to his wife ceases. As a result, there is no basis for the view that the income from the trust has, in effect, been reserved by the husband for life because it is being used to meet an obligation that continues until his death.

Husband's death before funding

If the husband dies before funding the alimony trust, or before completion of its funding, his executor may have to discharge that obligation. The question then arises whether a deduction from the gross estate is allowable for the cost of the funding. The estate tax statute provides that a deduction is allowed in the case of claims "founded on a promise or agreement" only "to the extent that they were contracted bona fide and for an adequate and full consideration in money or money's worth."[11] If the husband's obligation to fund the alimony trust is founded on a decree of the court, it is not regarded as founded on a "promise or agreement," and, therefore, the requirement of an adequate and full consideration in money or money's worth is not required to be met. In such a case, the executor can obtain a deduction for the funding of the trust. However, if the agreement has not been merged into or adopted

[10] Comm. v. Dwight's Estate, 205 F2d 298 (2d Cir. 1953), *cert. denied*, 346 U.S. 871. Alimony trusts are in little danger of attack as transfers in contemplation of death. See Cowles v. United States, 152 F2d 212 (2d Cir. 1945).
[11] Section 2053(c)(1)(A).
[12] Comm. v. Mesta, 123 F2d 986 (3rd Cir. 1941); Comm. v. Halliwell, 131 F2d 642 (2d Cir. 1942).
[13] Edna W. Gardner Trust, supra note 8.
[14] 39 BTA 510 (1939).
[15] See Proposed §§1.1014-4 and 1.1015-1(b).

by the court decree, it is deductible only to the extent it was contracted for consideration in money or money's worth, i.e., to the extent it was contracted in consideration of the relinquishment by the wife of her right to support.

In summary, the absence of court decisions upon the includibility of alimony trusts in the gross estate of the grantor-husband indicates that the Commissioner has not attempted their inclusion. He has, however, denied deductions for post-death funding by the husband's executor. This denial is sustained unless the executor's obligation is founded in a court decree or unless the obligation was sufficiently supported by consideration in the form of the wife's relinquishment of her right to support. Inexplicably, the estate tax has no counterpart to the statutory provision freeing from gift tax transfers to the spouse or for the support of the children made pursuant to written property settlement agreements entered into within two years preceding a decree of divorce.

INCOME TAX

The husband has been held to realize gain or loss upon the transfer of property to the wife in satisfaction of his familial obligations of support and of dower.[12] The measure of the husband's gain or loss is the difference between his basis in the property transferred and the value of the claims released by his wife or children. The tax is due whether or not the transfer is approved by a court, or, for that matter, whether or not the parties subsequently become divorced.

The theory upon which the husband is taxed is that of an exchange: he has exchanged property for the release of his legal obligation. The discharge of familial obligations is thus treated no differently from the discharge of a fixed indebtedness by transfer of property. Since the Commissioner and the courts are unable to ascertain the value of the wife's right to support and dower, they assume the transaction to be an arms'-length one in which the parties dealt with those rights as having a value equal to the fair market value of the property transferred by the husband. If the husband first converts the wife's right into a dollar obligation, and then satisfies that obligation by the transfer of appreciated property, the amount realized for the purpose of computing gain is the amount of the obligation.

Consistently with the foregoing, the wife is treated not as a donee but as a purchaser for a fair consideration. She should obtain a basis for the property measured by its cost to her, i.e., the fair market value of the support and marital property rights which she released. Here also, due to the difficulty of valuing those rights, resort is had to the fair market value of the property transferred in the settlement. Unless the parties first create a dollar obligation in discharge of the wife's rights, the cost of the property to her will be equated with its fair market value at the time received.

Transfer to children as gift

Where the alimony trust provides that the income shall be paid to the wife and the remainder shall pass to the children, the disposition of the remainder to the children is not in satisfaction of a legal obligation, since the father's obligation to support his children during their minority does not include an obligation to leave an inheritance. The transfers for the benefit of the children would thus seem to be gifts. Few principles in income tax law are as well established as that a donor does not realize gain upon his gratuitous transfer. Accordingly, where the husband makes a donative transfer of property in connection with a marital settlement, he should not realize gain or loss. As a corollary, the transferee should be required to take over the transferor-husband's basis.

Gain or lose on transfer to trust

The courts have not been asked to determine whether the husband realizes gain or loss upon the transfer of property to an alimony trust. The lack of conflict implies that the Commissioner has not asserted taxes and taxpayers have not claimed losses on such transfers. However, in a recent case the Tax Court permitted the trustee of an alimony trust to use as the basis of the assets transferred in trust by the husband their fair market value at the time of transfer[13] The Tax Court's opinion rested upon its finding that the transfer in trust was not a gift. Surprisingly, the Commissioner apparently did not even argue that the children were gratuitous recipients of the remainder.

As a corollary to the result reached by the Tax Court, the husband should have been subjected to a capital gain tax, based on the excess of the fair market value of the property at time of transfer over its cost to him. However, these simple rules of thumb do not work if the transfer is considered partly a gift and partly for consideration. This may be illustrated by the following figures: assume that the husband creates a trust, the income from which is payable to the wife, and the remainder distributable to the children. The remainder is a gift by the husband. The husband's basis in the total property transferred was $100,000. The market value of that property is now $250,000. This value may be broken down as follows: the wife's life interest is worth $150,000; the remainder $100,000. Thus, two-fifths of the total value of the property transferred is a gift to the remaindermen.

The soundest approach in this situation would seem to require no imposition of capital gain tax. The husband has not parted with the property itself for a consideration. Instead, he has provided that the future income from the property during the wife's lifetime shall be used to discharge his support obligation. The assignment of income from property in discharge of an obligation is not an "exchange" of the property. In the absence of any specially provided income tax treatment, the assignor should simply remain taxable on the income. However, Section 71 specifically taxes that income to the wife. If the husband had retained the property and applied the income therefrom in discharge of his support obligation as alimony, he would not pay any tax. There is no consistency in requiring him to pay a capital gain tax merely because in connection with a gratuitous transfer to his children, he allocates the income from the property to the discharge of the support obligation.

Another possible, but less attractive, approach is suggested by the case of *Reginald Fincke*.[14] That case involved a disposition of property partly by gift and partly for money consideration. However, it was not a disposition of the future income for a consideration and gift of the remainder. The Tax Court held that the transferor of the property could allocate his basis in the property entirely against the proceeds of the sale. Thus, if the property cost $100,000 and has a present fair market value of $250,000, gain of $50,000 would be realized if the property were disposed of for $150,000, the excess $100,000 in fair market value representing a gift.

From the basis standpoint, the extension of the *Fincke* rule to alimony trusts

would not be attractive. Under *Fincke* the transferor's basis would be allocated entirely to the wife with the result that the remainderman's basis would begin at zero. Under standard principles, the unrecouped basis of the wife should shift over to the remainderman, so that at the termination of the life estate the basis of the remainderman's interest should be identical with that of the wife's interest at the date of creation.[15] Intervening sale of the wife's interest, or sale of property by the trust, would complicate matters.

Trusts are often less simple than the one which has been assumed. The wife may be a possible remainderman. The trustee may be empowered to invade the corpus of the trust for the wife's benefit. That power may or may not be subject to a measurable standard. Various contingencies may make the interests of the wife and children actuarially inseparable.

There are other complexities. As has been noted, the wife rather than the husband may be the children's benefactor. In other cases they may be joint benefactors of the children. Since the wife's rights are not easily susceptible of valuation, it is difficult to tell whose bounty the children are enjoying.

This income tax question must be regarded as unsettled. Various difficulties probably make the *Fincke* rule unworkable. The law may develop on a case-by-case basis, depending upon the findings of the trial court as to the presence and adequacy of consideration. If a general rule is to be adopted, the most promising one is that of no gain or loss to the husband and a carryover of his basis to the trust.

TAXES ON TRUST INCOME

Since 1942 the tax treatment of income used for the wife's support has been roughly the same for the three methods of satisfying the legal obligation. Prior to that time the husband who could afford to satisfy his obligation of support by a lump-sum payment enjoyed a considerable tax advantage. For income earned by the transferred property was taxable to the wife rather than the husband. In contrast, if the husband paid his alimony by periodic payments or by an alimony trust, he rather than his wife was taxable on the income composing the payments, and he received no offsetting deduction.

The disparity between lump-sum property settlements and periodic payments of alimony was removed in 1942 by what are now Sections 71 and 215 of the 1954 Code. Section 71 provides that "periodic payments" to a wife in discharge of an obligation of support incident to a decree of divorce or separation, a written separation agreement or a decree for support, are taxable to the wife. Payments from her husband's principal as well as income are taxable to her. Concomitantly, Section 215 allows the husband a deduction for amounts includible in his wife's income under Section 71.

Similar tax treatment for the income payable by alimony trusts is prescribed by two sections of the 1954 Code. Section 682 governs trusts created before divorce was contemplated but used to pay alimony after divorce. These trusts will be referred to as pre-existing trusts. Section 71 deals with trusts created incident to divorce or separation, or by a written separation agreement, or by a decree for support.

Both sections adhere to the principle that the wife rather than the husband is taxable on income paid to her for her support. Section 682 differs from Section 71 in only one important respect. Section 71 requires all payments to the wife from a trust created incident to divorce or separation, whether they be from principal or income, to be included in the wife's gross income. However, Section 682 requires the wife to include only income, not principal, of a pre-existing trust for her benefit. Thus, where it is necessary to dip into corpus, the use of a pre-existing trust may save the wife some tax without increasing the tax of the husband.

Both pre-existing trusts and trusts incident to divorce, if stocked with tax-exempt securities, afford tax-savings to the wife, not obtainable through periodic payments of alimony. The income from the tax-exempt securities in trust is taxable to neither husband nor wife. Particularly where the wife has a substantial amount of other income, the yield of the trust to the wife after taxes may be increased through total or partial investment in tax-exempt securities. This would permit the husband to provide for the wife through a smaller transfer in trust than would otherwise be required. If, however, the husband retained the tax-exempt securities and used the income therefrom to pay alimony to his wife, she would be required to include the full payment in her income.

If, subsequent to the divorce, the husband decides to pay the wife additional sums for her support, he runs the risk of not being entitled to a deduction. For Section 71 taxes to the wife only sums paid in discharge of a legal obligation. If the legal obligation has been discharged at the time of the divorce, the subsequent increase will be taxed to the husband rather than the wife. It may, therefore, be advisable to frame the divorce decree so that the court retains jurisdiction over alimony. In such a case, the obligation of support is not discharged with finality and subsequent increased payments may qualify for the deduction.

Support of children

Amounts paid by an alimony trust for the support of minor children are taxable to the husband rather than to the wife. An amount is considered paid for the support of minor children only if it is expressly earmarked for their use or if that use is identifiable by a collateral provision of the trust. For example, if the trust provides that alimony payments to the wife are to decrease by 40% upon the child's attaining majority, it will be assumed that the 40% was for the support of the child.

If the aggregate income paid for the support of the wife and children is less than the amount specified in the trust, whatever income is paid will be attributed to the children's support to the extent of the sum specified as payable for such support. Only the excess will be taxed to the wife rather than the husband.

If the trust agreement provides that a sum is payable to the wife for the support of her and the children, and in no way identifies, either expressly or impliedly, the portion intended for the support of the children, the husband will not be taxable on the amount spent for the support of the children. Instead, the entire payment of the income will be includible in the wife's gross income. Where the parties desire to place the income tax burden of the income used for the benefit of minor children on the wife because of the tax savings involved, they sometimes resort to very elaborate formulas designed to make it difficult or

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impossible for the Service to identify any amount as earmarked by the terms of the instrument for the support of the children.

Dependency deductions

Not only must the parties decide who is to bear the tax burden of supporting the children, but they must determine who shall be entitled to take the dependency deduction. Either the wife or the husband, but not both, is entitled to a dependency deduction for a child for whom she or he provides more than one-half of the support, and who otherwise qualifies as a dependent. But for the purpose of determining who provides more than one-half the support, payments to the wife which are includible in her income, though used for the support of the child, are credited to her.

Therefore, if the husband wishes the dependency exemption, he must not only earmark funds for the support of the child, but must also make sure that the earmarked sum covers more than one-half of the child's support. In determining whether more than one-half the support is contributed by the husband, arrearages paid in the current year for support payments due in prior years may not be taken into account. An understanding between the parties as to which of them should be entitled to the dependency exemption should be entered into at the time the separation agreement is drawn. Such an understanding, although not binding upon the Government, since the test is that of the source of the chief portion of the support, will at least eliminate inconsistent positions by the two parties and thus reduce the chances of a tax dispute in the future. ☆

New decisions affecting individuals

"Alimony" not periodic is not deductible. Taxpayer was to pay his wife between $1,000 and $1,500 a month, depending on his income, for twelve years and was also to pay $7,200 to her immediately after the entry of the divorce decree. The deduction for the $7,200 is not allowed because it was not a periodic payment. *Lowry,* DC Ill., 3/4/57.

No alimony deduction for premiums on policies not assigned to ex-wife. Taxpayer paid premiums on life-insurance policies for the benefit of his divorced wife. The policies were not assigned to her. The Service holds that the premium payments do not qualify as periodic alimony payments because the wife is only a contingent beneficiary. *Rev. Rul.* 57-125.

Alimony pendente lite deductible despite prior unrecognized Mexican divorce. After a husband secured a Mexican divorce, his wife was awarded alimony pendente lite pursuant to a court decree in a state which does not recognize the validity of the Mexican divorce. The fact that the Mexican divorce preceded the award is held not to preclude its deductibility as alimony. *GCM* 25-250 held that alimony under a Mexican decree was deductible even though the decree was not recognized in many states. However, that should not be interpreted as "recognition" by the Service of Mexican decrees over subsequent decrees in other jurisdictions. *Rev. Rul.* 57-113.

Wife's advances not a loan to husband; were for new home. Taxpayer advanced $17,000 to her husband for a personal residence which was intended to be their home. Upon a subsequent property settlement pursuant to a separation agreement she attempted to treat the advance as a "loan" and took a bad-debt deduction for the nonreimbursed portion. The court holds she was not entitled to the deduction because the sum advanced was a purely personal expenditure and was not intended as a loan. Even if it were a loan it did not become worthless in the taxable year since the facts showed that the husband was a man of some wealth. *Bartos,* 27 TC No. 123.

Employee taxable on "health cure" at resort. Noting the advertisements which have appeared in magazines for "tax deductible" health plans at resorts, the Service rules that payments by an employer for an executive-rehabilitation plan under which executives can avail themselves of reconditioning and health-restoring services afforded by certain resort hotels and athletic clubs are compensatory in nature and are deductible as such by the employee. They are, however, additional income to the employee. An individual making the payments himself may not deduct them; they are a personal expense. *Rev. Rul.* 57-130.

Teacher taking standard deduction denied summer-school expense. Taxpayer-teacher elected to take the standard deduction. She could not, in addition, deduct dues to teachers' associations and summer-school expenses for courses required to renew a teacher's certificate. Such expenses are deductible only from adjusted gross income. The court notes the standard deduction is higher than these items and allows it. *Thompson,* TCM 1957-62.

Travel to favorable climate not medical expense [*Acquiescence*]. Taxpayer, a retired businessman in his 70's living in St. Louis, suffered from generalized arteriosclerosis. The Tax Court held that trips to the south in winter and to a northern state in summer did not qualify as medical expense. This court affirms. Only rarely can travel costs escape classification as personal expenses. It quotes with approval the Tax Court's comment that when the taxpayer chose to travel rather than stay the year around in a favorable climate, the expense was personal. *Rodgers,* CA-8, 3/8/57.

Painter can't deduct work clothes. A painter's work clothes, even though prescribed by his local union, are not distinctive in character nor are they a uniform. The cost and maintenance of such clothes are therefore a nondeductible personal expense. *Rev. Rul.* 57-143.

Legal cost of defending unsuccessfully tax-evasion case not ordinary and necessary. Expenditures by a partnership for legal and accounting fees in defense of criminal proceedings against the individual partners for income tax evasion are held to be essentially personal in character and hence not deductible as a business expense. (The partners had pleaded guilty.) *McFarland,* TCM 1957-52.

Can't entertain with liquor in dry state. Entertainment expenses incurred by an Oklahoma firm represented expenditures for liquor. They are denied as a business deduction since the purchase and sale of intoxicating liquor is prohibited in the state. *O'Shea,* TCM 1957-15; *Finley,* TCM 1957-16.

NEW DEVELOPMENTS IN

Taxation of oil & gas

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Southwest Exploration case does not clarify economic-interest doctrine

by WILLIAM P. McCLURE

When the Supreme Court granted certiorari in the Southwest Exploration case, many practitioners hoped that the long-existing confusion about the economic-interest doctrine in oil-depletion matters would at last be ended. But the Court decided the case as merely another step in a piecemeal development of the economic-interest concept. In this article, the second in a series based on his talk before the Southwestern Legal Foundation, the author, a Washington, D. C. attorney, analyzes the meaning of what the Court said and left unsaid; he also reviews recent developments on depletion for captive mines and allocation by a trustee.

EVER SINCE the decision of the Supreme Court of the United States in *Burton-Sutton Oil Co. v. Commissioner*,[1] it has been hoped that the Supreme Court would reconcile the decisions of that Court in *Helvering v. Elbe Oil Land Development Co.*[2] and *Helvering v. O'Donnell*[3] with *Burton-Sutton* and *Kirby Petroleum Co. v. Commissioner*.[4] The feelings of many were succinctly expressed by Justice Frankfurter when he said in his famous dissent in *Burton-Sutton*:

"Nothing better illustrates the gossamer lines that have been drawn by this Court in tax cases than the distinction made in the Court's opinion between *Helvering v. Elbe Oil Land Development Co.* and this case. To draw such distinctions, which hardly can be held in the mind longer than it takes to state them, does not achieve the attainable certainty that is such a desideratum in tax matters, nor does it make generally for respect of law. Perhaps it is inherent in the scheme which Congress has provided for review of tax litigation that we have such an unsatisfactory series of decisions as those which are sought to be reconciled by the present opinion. If so, then the call for legislation voiced in responsible quarters to reform the situation may well be heeded. See e.g., Griswold. The Need for a Court of Tax Appeals (1944) 57 Harvard L. Rev. 1153."

When the Supreme Court granted certiorari in *Commissioner v. Southwest Exploration Co.* and in *Huntington Beach Co.*, it had an opportunity to clear up "the gossamer lines" that it had drawn in previous cases. Much to the disappointment of many, however, the Supreme Court did little other than decide the particular case at hand, leaving the existing confusion to be dispelled, we hope, by later decisions.

In the *Southwest Exploration Co.* case,[5] the taxpayer sought a lease from the State of California to develop certain offshore oil deposits. The California law provided that California offshore oil must be extracted only from wells which are drilled on filled lands or slant-drilled from upland drill sites to the submerged oil deposits. State law further required that all machinery and equipment be located on filled lands or uplands. Under the state law the state leasing authority could require each prospective bidder to furnish as a condition precedent to the consideration of its bid, satisfactory evidence of a present ability to comply with the drilling-site requirements. Even after granting a lease, the state possessed statutory powers to close down any wells which failed to comply with the drilling site requirements and to cancel leases in default of this condition. In the area in which the taxpayer was operating, the creation of filled land sites was not commercially feasible; therefore, the taxpayer, in order to have its bid considered, had to obtain the right to utilize upland drilling sites. Accordingly, Southwest entered into certain agreements with the Huntington Beach Company and other upland owners for the use of their shore properties as drill sites. Under the agreement with Huntington Beach, Southwest was granted an easement on designated uplands with the right to use on those uplands any equipment necessary for drilling. In return for this easement, Southwest agreed to pay Huntington Beach 24.5% of the net profits obtained from the extraction and sale of the oil. It was specifically agreed that Huntington Beach would not acquire a share in the lease or in the oil deposits and further that it was not the intention of the parties to create a partnership.

Southwest thereafter filed its bid for a lease, was granted a lease by the state, drilled producing wells from Huntington Beach's upland and paid Huntington Beach its 24.5% of the net profits according to the agreement.

On their respective income tax returns, both Southwest and Huntington Beach claimed depletion on that part of the "net profits" paid by Southwest to Huntington Beach. The Tax Court and the Court of Appeals for the Ninth Circuit agreed with Southwest that it was entitled to depletion on this in-income. The Court of Claims, however, agreed with Huntington Beach that it was entitled to depletion on the very same payment. The two decisions conflicted therefore not only in legal principle, but in the precise treatment to be accorded a particular payment, since both cases dealt with the same transaction. On petitions, the Supreme Court granted review in both cases.

Southwest exploration decision

The Supreme Court, after reviewing its prior decisions dealing with the concept of an economic interest, held that

[1] 328 U.S. 25 (1946).
[2] 303 U.S. 372 (1938).
[3] 303 U.S. 370 (1938).
[4] 326 U.S. 599 (1946).
[5] Commissioner v. Southwest Exploration Co., 350 U.S. 308 (1956), consolidated with United States v. Huntington Beach Co.
[6] 287 U.S. 551 (1933).
[7] GCM 22730, 1941-1 CB 214.

Huntington Beach — the upland owner — and not Southwest, was entitled to the depletion allowance, stating that the agreement between Southwest and Huntington had resulted in the conveying of economic interests in oil in place to Huntington and the other upland owners. In determining that economic interests passed to the upland owners, the Supreme Court relied on its decision in *Palmer v. Bender*[6] which held that a taxpayer is entitled to depletion where he has:

1. Acquired by investment any interest in the oil in place, and,

2. Secured by legal relationship income derived from extraction of the oil, to which he must look for the return of his capital.

The Supreme Court, in the *Southwest* case, concluded that these two factors, considered together, constituted the requirement of "an economic interest." After stating that the second factor had been interpreted to mean that the taxpayer must look *solely* to the extraction of oil or gas for a return of his capital, the Court pointed out that no one seriously disputed that this requirement had been met.

The Court therefore concentrated on the real problem of whether or not the first requirement had been met — that is, whether Huntington Beach had by investment acquired an interest in the oil in place. The Court had little trouble in holding that the upland owners' contribution of land was a sufficient investment in the oil in place to give them economic interests in the oil in place. Of paramount importance was the fact that Huntington's strategic position as the owner of the upland site made it a necessary party to any successful exploration of the deposit. Without Huntington's permission and consent, Southwest could not have drilled the wells. In this connection the Court said:

"Recognizing that the law of depletion requires an economic rather than a legal interest in the oil in place, we may proceed to the question of whether the upland owners had such an economic interest here. We find that they did. Proximity to the offshore oil deposits and effect of the state law combined to make the upland owners essential parties to any drilling operations. This controlling position greatly enhanced the value of their land when extraction of oil from the state's offshore fields became a possibility. The owners might have realized this value by selling their interest for a stated sum, and no problem of depletion would have been presented. But instead, they chose to contribute the use of their land in return for rental based on a share of net profits. This contribution was an investment in the oil in place sufficient to establish their economic interest. Their income was dependent entirely on production, and the value of their interest decreased with each barrel of oil produced. No more is required by any of the earlier cases."

It is interesting to note that this is the first decision by the Supreme Court holding a taxpayer to have an economic interest where he did not at one time hold at least a fee or leasehold in the oil-producing properties. This decision therefore should dispel any fear that depletion would be denied a taxpayer *solely because* he was not—at one time—in the chain of title to the oil-producing properties.

In conclusion, Southwest argued that if depletion were allowed the upland owners, it would be difficult to limit the principle established in this case in instances where strangers disassociated from the lease contributed an essential facility to the drilling operation in return for income from the property. The Court quashed this argument by saying that the problem was not before the Court since the upland owners could hardly be strangers disassociated from the lease, since without them drilling could not have been commenced.

Certainly, there can be little if any argument with the Court's decision in its result. Even though this case was the first one before the Supreme Court where the taxpayer had never been in the chain of title, most tax practitioners never seriously thought that there was any requirement that in order to have an economic interest one must be or have been in the chain of title. Further, as is well known, it has been a well-established practice of the Service not to regard the chain-of-title doctrine[7] as a necessary incident to the possession of an enonomic interest.

The Supreme Court was afforded in this case an opportunity to clarify generally the entire area of the law defining economic interest and either to reconcile or overrule certain of its earlier decisions which appear to be mutually inconsistent. Unfortunately, the Court did not take advantage of this opportunity but decided the *Southwest* case as merely another step in a piecemeal development of the economic-interest concept. For this reason this decision may be remembered for what it failed to do rather than for what it actually decided.

Allocation of depletion by a trustee

Rev. Rul. 56-105, published during the early part of 1956, considered a trust instrument which gives the trustee sole discretion to allocate the depletion between the income beneficiaries and the trust. The IRS held that the trustee could allocate all of the depletion deduction to income beneficiaries and retain none for the trust although a substantial portion of the income from the depletable assets was retained by the trust. The question which immediately arose was whether a portion of the depletion deduction could be allocated to a beneficiary in an amount which exceeded the portion of the income from the depletable asset which was allocated to the beneficiary. In view of the unqualified language of the Code provision dealing with allocation,[8] certainly a Ruling would be justified that as long as the trustee had complete discretion in allocating the depletion deduction, he could effectively allocate it in any manner he saw fit irrespective of the amount of income distributed to the beneficiary.

However, that this Ruling would soon be overruled became clear on the issuance of the final depreciation Regulations. Code Section 167(g) [depreciation] and Section 611(b)(3) [depletion] both relate to the allocation of the deductions between the income beneficiaries of a trust and the trustee. They contain almost identical terminology providing in each instance that the deduction "shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each." The final depreciation Regulations clearly state that no effect shall be given to any allocation of the depreciation deduction which gives any beneficiary or the trustee a share of the deduction greater than his pro rata share of the trust income irrespective of the words of the trust instrument. The

[8] Section 611(b)(3) of the 1954 Code provides that the deduction ". . . shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each."
[9] GCM 22730, 1941-1 CB 214.
[10] Amounts paid in for stock.

only exception to this rule as set forth in the Regulations is a provision which allows the trustee to allocate the depreciation deduction to the trust to the extent that the trustee is required or permitted under the terms of the trust instrument or by local law to maintain a reserve for depreciation.

The fears which the depreciation Regulations incited regarding the validity of *Rev. Rul.* 56-105 and the Government's regulatory interpretation of Section 611(b)(3) were fully justified as shown by the *proposed* natural resources Regulations which were issued on November 3, 1956. These Regulations included a provision that the depletion deduction is:

". . . to be apportioned between the income beneficiaries and the trustee on the basis of the trust income allocable to each, unless the governing instrument (or local law) requires or permits the trustee to maintain a reserve for depletion in any amount. In the latter case, the deduction is first allocated to the trustee to the extent that income is set aside for a depletion reserve, and any part of the deduction in excess of the income set aside for the reserve shall be apportioned between the income beneficiaries and the trustee on the basis of the trust income (in excess of the income set aside for the reserve) allocable to each . . ."

It is virtually certain that this provision in the proposed Regulations will appear in the final Regulations without substantial change, thereby effectively overruling *Rev. Rul.* 56-105.

The limitation contained in the proposed Regulations is clearly inconsistent with the language of the Code which appeals to support fully the holding of *Rev. Rul.* 56-105. However logical or equitable the proposed Regulations may be in the matter of allocation, the fact remains that the restrictions which they impose find no support in the statute they purport to interpret.

Captive mine depletion

Although the Service has at various times issued private unpublished Rulings on the subject, *Rev. Rul.* 56-542 is the first published Ruling dealing with captive mines. The usual pattern of operations for a captive mine involves a few mining companies each of which requires several kinds of ore. The companies unite with each other in an arrangement for the acquisition of mining property to be jointly exploited, developed and operated. The joint ownership and control is accomplished through a separate corporation organized and owned only by the participants. By agreement with each other and with the operating corporation each participant proportionately with its percentage of stock ownership advances the funds needed by the operating company for capital and operative purposes and in the same proportion receives its share of the ore produced. The agreements also provide that the "captive mining company" will not sell any ore, that it will have no net income, and that its operations as well as the disposition of the product mined will at all times be under the control of the shareholders.

The question in such cases is whether the economic interest in the ore being produced by the "captive mining company" is in that company or in its shareholders.

For many years the Service has taken the position in other factual situations that the existence of an economic interest depends upon the right to share in production and does not depend upon the legal title to the mineral deposits.[9] Thus, consistent with its prior pronouncements, the Service in *Rev. Rul.* 56-542 declared that whether or not a depletable interest exists in the "captive mining company" rather than the shareholders depended upon the substance of the agreement. The Service further ruled that for the shareholders to establish that they have the economic interest in the ore rather than the "captive mining company," they must show that the following four factors exist:

Four important factors

1. The shareholders, and they alone, each have the right to take their individual shares of the ore produced (or the proceeds thereof);

2. They have no source other than their respective shares of the ore produced (or the proceeds therefrom) from which they may recoup any investment or advance they have made or may be required to make under the existing agreements.

3. They contributed capital[10] of the mining company is nominal in relation to the working capital required for the to manage the mine; and

4. The contributed capital of the mining company is nominal in relation to the working capital required for the mining operation.

If these four tests are met, the shareholders of the "captive mining company" are entitled to the depletion deduction, by virtue of the rights acquired under the contract entitling them to the ore produced and obligating them as joint venturers to furnish the funds needed by the mining company to develop and operate the mine.

Although this Ruling related to the mining of hard minerals, the same or similar types of arrangements have been utilized in the oil and gas industry, particularly in connection with foreign operations. Although no published Rulings have been issued dealing with oil and gas, it is understood that private rulings have been issued declaring that the shareholders of a "captive producing company" (under circumstances similar to those set forth in *Rev. Rul.* 56-542) have the economic interest in the oil and gas in place and are therefore entitled to the depletion deduction. Logically it should follow that in such a situation the shareholders and not the "captive producing company" are also entitled to make the election as to the treatment of intangibles.

Fringe benefits and depletion

Section 613(a) of the 1954 Code limits the percentage depletion allowance to 50% of the taxpayer's taxable income from the property involved. An interesting Ruling issued last year dealt with whether or not costs incurred in the operation of nonproducing activities (such as furnishing personnel with housing, food, supplies, etc.) should be deducted in determining the taxable income for purposes of applying the 50% limitation. The Service in *Rev. Rul.* 56-433 held that where the taxpayer is operating such nonproducing activities and it appears that a reasonable attempt is being made to charge the personnel a price that will return expenses and a reasonable profit, the profits or losses should be excluded from taxable income in computing the percentage depletion limitation. On the other hand, the Service ruled that where it appeared that the taxpayer is operating these nonproducing activities for the purpose of providing such services either without cost or at a price which consistently results in a loss, the losses of providing such services must be taken in to account in computing the percentage depletion limitation, since in substance they represent additional compensation to employees and therefore are expenses incident to production activities. ☆

NEW DEVELOPMENTS IN

Foreign aspects of taxation

EDITED BY SIDNEY I. ROBERTS, LL.B., CPA, JOHN COSTELLOE, LL.B., AND JOHN WILCOX, LL.B.

Skillful use of base company increases tax savings obtainable in tax havens

by **WILLIAM J. GIBBONS**

The popular concept of a tax haven is a sort of utopia where the best of tax advantages are obtainable. But this picture, as reassuring as it is, can be made even brighter. Sometimes the seeming utopia can be improved and better tax advantages can be obtained by the skillful use of a base company in one of the tax havens. These possibilities, and the advantages and pitfalls of a base company, are here discussed by the author, a member of the Illinois bar, in an article based on certain material appearing in more extended form in the Harvard Law Review.

A BASE COMPANY is a corporation or other limited-liability company organized in a base country for the purpose of conducting third-country operations. And a base country is any one of the more than forty countries which either grant preferential tax treatment to foreign income earned by companies organized under their laws or levy no income tax on foreign or domestic income.

ADVANTAGES

When a U. S. corporation either engages in or plans to engage in business in one or more foreign countries, there are at least eight reasons why it should organize a base company to direct its operations.

1. Accumulation of profits abroad

It will be able to withdraw the profits from operations in the country where active trade or business is carried on and accumulate them in a base company, safe from expropriation and future exchange controls by the country where active business is carried on, without the payment of a U. S. tax. Accumulated foreign earnings do not have to be kept on deposit in the base country but may be placed in banks in other countries, including the U. S., as foreign funds. In effect, the tax-free accumulation of foreign earnings in a base company permits the parent to use for new investment that portion of foreign income which would have been paid to the U. S. in the form of taxes. In the event that the U. S. parent sells goods abroad, it can use the funds accumulated in its base company to finance foreign sales, releasing the parent's own funds formerly used to finance foreign sales for other purposes. Direct loans can also be made by the base company to its U. S. parent, but there is considerable danger that such loans will be deemed to be dividends, especially if they are large and appear to be made in lieu of dividend distributions.

If the parent were to do business directly through a branch in the country where active trade or business is carried on, it would be taxed by the U. S. upon all profits earned by the branch whether or not these profits were returned to the U. S. Or if it were to operate directly through a subsidiary corporation, foreign income could be accumulated in the subsidiary without payment of a U. S. tax, but present or future exchange controls in the country where business was done might prevent the withdrawal of funds when needed, or the utilization of these funds elsewhere.

If the country where active trade or business is carried on specially taxes the accumulation of earnings by its domestic corporations, considerable tax-savings may be effected by distributing these earnings to an intermediate base company where they will be free from both U. S. and foreign taxes. On the other hand, if the parent operates through a directly controlled subsidiary corporation in the country where active trade or business is conducted, the only alternative to payment of a local accumulated earnings tax may be the distribution of such earnings to the parent in the U. S., where they will be subject to tax at the rate of 52%.

2. Dissolution of base company

The parent can dissolve its base company without disturbing the foreign operating companies controlled by the base company. Foreign earnings which have been accumulated in the base company and any appreciation in its assets can then be returned to the U. S. via the capital gain route to be taxed at a rate of only 25%. No credit under Section 902 will be allowed, however, for foreign taxes paid by the base company or its operating subsidiaries to the country where active trade or business is carried on if the base company is dissolved and its accumulated earnings are thus returned to the U. S. This may result in less favorable tax treatment than if the parent had brought back its accumulated foreign earnings via the conventional dividend route, because in the latter case the parent will obtain, within the limits of Section 904, a credit for foreign "income, war profits, or excess profits tax" paid by the base company and its operating subsidiaries.

Actually, the parent will receive no tax advantage by dissolving its base company and bringing the latter's accumulated foreign earnings home via the capital gain route so long as effective income tax rates are 27% or higher in the countries where active business operations are conducted (27% foreign tax plus 25% capital gain tax equals 52%, the ordinary U. S. income tax). If the effective foreign tax rate is below 27%, however, the parent will always reduce its total tax bill by employing the capital gain route.

An American parent corporation probably cannot bring its earnings back to the U. S. without being taxed. The tax-free merger, consolidation, and reorganization provisions of the 1954 Code are generally not available to a

U. S. parent corporation in view of Section 367. Nevertheless, a U. S. parent may be able to use the accumulated earnings retained by its subsidiary base company as effectively as if these earnings were actually returned to the U. S.

3. Tax-savings on branch operations

The parent can carry on its ultimate business operations through a branch or agent of the base company and still receive the same favorable U. S. tax treatment as that accorded a foreign subsidiary corporation. Since the base company is not subject to U. S. tax jurisdiction, income from that company's branches or agents operating in other countries can be accumulated in the base company without payment of a U. S. tax. When the income is paid to the parent in the form of dividends, the parent will, in effect, receive the benefit of a deduction for all foreign income taxes paid by the foreign branch or agent of the base company as well as a credit for those foreign taxes. Under present law, only a credit against U. S. taxes is obtained for foreign taxes paid by a branch or agent operating directly out of a U. S. corporation, since the full amount of the foreign income, unreduced by any foreign tax on it, is included in U. S. income.

4. Tax-free transfers

The parent can transfer profits from one foreign operating unit to another in the process of building up its capital abroad without being subject to a U. S. income tax on the transfer. If, for example, profits from an operation in Brazil are sent to an operation in India, the transfer will flow through the base company, a foreign corporate entity not subject to U. S. tax.

On the other hand, if the parent is engaged in business directly in Brazil and India through operating subsidiary corporations in those countries, the doctrine of constructive receipt of income might be applied to lateral transfers of capital or profits between the subsidiaries. It may be more difficult for the U. S. to tax lateral-loan transfers under the constructive-receipt theory. In practice, however, loan transfers may be forbidden by the corporation laws of the country in which the subsidiaries are located, especially if the subsidiaries are not wholly owned by the U. S. parent.

5. "Averaging" of foreign tax rates

The parent corporation can take fullest advantage of the foreign-tax credit provisions of Section 902 by averaging foreign-tax rates in excess of 52% with those foreign rates which are less than 52%. If the parent were to operate abroad directly through branches or subsidiaries, the per-country limitation of Section 904 would prevent the crediting of any foreign country's taxes in excess of the U. S. rate. By organizing a base company, however, the parent can eliminate the restrictive effect of the per-country limitation, since the Service has ruled in *IT* 4089 that all income taxes paid by a foreign holding company's subsidiaries are deemed to have been paid by the holding company itself. This ruling is the only direct authority for according special tax treatment to base companies. It should be noted that the ruling may, of course, be withdrawn by the Commissioner or disregarded by the courts. [This ruling is incorporated in the proposed Regulations.]

6. Passage of title

If the parent corporation carries on all its export-import activities through a base company, income from these activities may under some circumstances be exempt from U. S. tax. This follows from the fact that a U. S. income tax is imposed upon a foreign corporation only if its income arises from sources within the U. S. In determining where income arises, the Commissioner now generally applies the title-passage test. Therefore, if title passes abroad to goods which are imported into or exported from the U. S., no U. S. tax will normally be assessed on income accruing to the base company from the transaction.

At the same time, the foreign importing or exporting country will not levy a tax against income resulting from such sales, if that country also employs the title-passage test in determining where income arises, and title to the goods is passed elsewhere. The base company may employ an agent in a free port of a third country expressly for this purpose. If the foreign importing or exporting country applies an "activity" or "doing-business" test to determine where income arises, sales or purchases within that country will generally not be subject to an income tax, provided they are made through independent contractors. The foreign base of incorporation will not tax income received by a base company from export-import transactions conducted between third countries, particularly if title does not pass in the foreign base of incorporation, since such income will in most instances be deemed to have arisen from foreign sources.

The typical pattern of such an operation conducted by a U. S. producer is outlined in the following example. The parent organizes a base company which in turn establishes a branch near the parent's factory. The parent transfers to the branch its employees and assets formerly devoted to the conduct of foreign-export operations. At the same time, all foreign-based sales personnel formerly employed by the parent become employees of the base company. The base company then solicits orders abroad for the parent's goods. When a sale is made by the base company, it purchases the necessary goods from its parent and resells them to its foreign customer. The markup on these goods by the base company, minus its expenses, represents its tax-free profits on the sale.

As an alternative, the base company may act merely as the foreign sales agent of its U. S. parent. In that event, the base company never takes title to the goods which it sells, but derives its income solely from sales commissions. Thus, title-passage problems are avoided, since the parent can ship its goods directly to the foreign buyer, title passing to the buyer in the U. S. The parent may deduct as an expense the sales commission paid to its base company. Sales commissions earned by the base company are not taxable in the U. S. since the base company is a foreign corporation whose income arises from sales activities conducted outside the U. S. Similarly, the sales commissions may be free from tax in the importing country, if the base company maintains no office there, conducts its sales through independent contractors, and accepts orders outside the importing country. Finally, no tax will be assessed by the base country on foreign sales commissions earned by the base company, since such income is clearly derived from sources outside the base country. Whether the base company should take title to goods and resell them abroad or act merely as a foreign sales agent will depend largely upon business custom and convenience and the law of the foreign importing or exporting country.

7. Organization of investment companies

Investment companies which are organized in base countries to invest in foreign securities in other countries may

provide a considerable tax advantage for wealthy American investors. A U. S. company investing in foreign securities and qualifying as a regulated investment company under Section 851 must pay out 90% of its income in order to escape a heavy corporate tax on its undistributed profits. If an investment company is organized in a base country, however, the profits of the company may be accumulated. Dividend payments to American shareholders may then be deferred or the accumulated profits may be returned to the shareholders via the capital gain route. A number of base-country investment companies have been organized in Canada to invest in other foreign countries and are permitted to sell securities in the U. S.

8. Base-country tax treaties

Assume that the parent corporation wishes to do business in country *A*, with which the U. S. has no tax treaty. A treaty has been concluded, however, between country *A* and a foreign base of incorporation. If the parent establishes a subsidiary in the foreign base of incorporation to do business in country *A*, the parent may then receive the benefits of the treaty between country *A* and the foreign base of incorporation. Similarly, if the base country has concluded a more advantageous tax treaty with country *A* than has the U. S., the parent may find that considerable tax-savings can be effected by operating abroad through a base company. [See item on Netherlands Antilles, page 377.]

PITFALLS

Eleven areas of possible pitfalls exist. They are the following.

1. Disregard of the corporate entity

None of the objectives listed above can be accomplished unless the corporate entity of the base company is respected by the courts. Although the courts have demonstrated considerable reluctance to ignore the corporate entity, there is enough authority in cases involving domestic corporations to indicate that real danger exits in organizing a base company which serves no useful purpose other than to reduce the impact of U. S. taxes.

In disregarding the corporate entity the courts have often emphasized one or more of the following factors:

1. The corporation filed no income tax return or claim for deduction or loss for any year.

2. No income was received by the corporation for any year.

3. The corporation engaged in no management activity with respect to the property it owned, maintained no offices, corporate records, or bank accounts, and generally did not observe formalities of corporate life such as directors' and shareholders' meetings.

4. The corporation was merely the alter ego of its individual shareholders — shown by the fact that it was closely held, owned property of a personal rather than a business nature, and was ignored by its shareholders in transacting corporate business.

5. The principal purpose for organizing the corporation was to avoid taxes.

2. Withdrawal of service rulings

Another pitfall may be encountered when foreign operations are planned around a base company with the intent of bringing foreign income back to the U. S. in the form of dividends. As stated on page 375, the Service has ruled in *IT* 4089 that an American parent corporation may credit taxes paid by the subsidiaries of its base company, even though the base company and the subsidiaries are not in the same foreign country. If the Treasury or the courts feel that foreign bases of incorporation are being employed to avoid U. S. taxes, the withdrawal of this ruling would do much to eliminate the attractiveness of base companies. However, the rule of IT 4089 has been incorporated in the proposed regulations.

3. Transfer of appreciated assets

If a U. S. corporation is investing abroad for the first time and wishes to organize a base company, it may be troubled by two Code provisions which prevent the transfer of appreciated assets from the United States to countries abroad without the payment of a capital gain or excise tax. Section 367 applies to any appreciated property, including stock, securities, plant, and equipment, while Section 1491 applies only to appreciated securities. As a result of these two sections, a corporation may prefer to operate abroad through a branch if it intends to make its investment in the form of appreciated property.

4. Reorganization of foreign operations

A U. S. parent corporation already conducting its foreign buiness through directly controlled foreign operating subsidiaries which hold substantially appreciated assets may face a number of difficult problems in the event that it wishes to reorganize its foreign operations around a base company. Should the foreign operating subsidiaries be dissolved as a result of the reorganization, a U. S. capital gain tax will generally be assessed against any appreciation in the value of the subsidiaries' assets over the original investment. If the U. S. parent does not wish to pay a capital gain tax upon reorganization, it may be able to keep the old operating subsidiary alive and establish a base company with a new operating subsidiary which can take over the old subsidiary's business. For example, the old subsidiary might lease or sell its plant and equipment to the new subsidiary or allow the new subsidiary to take over those sales activities or assets on which there is no capital gain tax to be paid. The method of transfer will depend largely upon the law of the country in which the operating subsidiaries of the corporation are doing business.

5. The principal-purpose test

The prohibitions set forth in Section 269 of the 1954 Code should also be considered when establishing a base company, although they would not appear to raise serious problems for this type of foreign business organization in most cases. Section 269 applies to acquisitions of corporations or corporate property "the principal purpose for which is . . . evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy . . . ." To date, effective enforcement of this provision has been hampered by the narrow view taken by the Tax Court of the section's principal-purpose test.

Section 269 would appear not to apply to a base company so long as the main purpose of establishing the company was to accumulate foreign earnings free of foreign taxes and exchange restrictions. Even if the Commissioner should succeed in surmounting the hurdle imposed by the principal purpose test, he may find it difficult to prove that deductions or credits not otherwise enjoyed by the U. S. parent will be secured by establishing a base company. Furthermore, it would appear doubtful that such tax-savings as those effected by bringing accumulated foreign earnings back to the U. S. via the capital gain

route would qualify as a "credit, deduction or other allowance" in spite of the broad definition given these terms by the Service.

6. The 'arm's-length requirement

If the base company or its subsidiaries are engaged in active trading operations with the American parent or its U. S. subsidiaries, Section 482 requires that such dealings be conducted on an arm's-length basis. However, transactions between the base company and its foreign subsidiaries or among the foreign subsidiaries themselves would not appear to be covered by the section, because there would be no loss of revenue to the U. S. no matter how "income, deductions, credits or allowances" were allotted among these foreign subsidiaries by the base company.

7. Income from U. S. sources

If a foreign corporation derives over 50% of its gross income from sources within the U. S. during a three-year period ending with the close of the taxable year, the dividends which it pays will be deemed to be income from sources within the U. S. in the proportion that the corporation's gross income from U. S. sources bears to its total gross income. These dividends are subject to a 30% tax upon receipt by nonresident alien shareholders.

A base company will be liable for tax on the receipt of dividends from another foreign corporation falling within the definition set forth above. Upon payment of tax by the base company, the effective rate of U. S. tax on each $100 of income derived from U. S. sources and distributed to the base company will be 51%. Moreover, the base company may also subject itself to the tax on unreasonable accumulation of earnings, and to the personal holding company tax, if it is closely held and receives from another foreign corporation income which is deemed to be derived from sources within the U. S.

8. Personal holding company provisions

Any domestic or foreign corporation which meets the requirements of Section 542 is a personal holding company. As defined in Section 542, a personal holding company is any corporation:

1. At least 80% of whose gross income consists of interest, dividends, royalties, gain on the sale of stock, or other receipts mentioned in Section 543; and
2. More than 50% in value of whose outstanding stock is owned, directly or indirectly, by not more than five individuals, not including certain charitable trusts.

A foreign corporation meeting these requirements will not be taxed as a personal holding company, however, *unless*:

1. More than 50% of its gross income from all sources is derived from sources within the U. S., for the period specified in Section 861(a)(2)(B), or
2. Some part of its stock is owned by citizens or residents of the United States. Corporations organized in Canada are also exempt if 50% or more of their stock is owned directly or indirectly by Canadian residents.

The personal holding company tax may effectively prevent a U. S. citizen or resident from participating in a foreign holding company which is controlled by nonresident aliens. For example, assume that five Panamanian citizens own more than 50% of the stock in a base company organized in that country for the purpose of investing solely in securities in the U. S. and other foreign countries. If even one citizen or resident of the U. S. becomes a stockholder in the base company, the personal holding company tax will apply, even though less than half of the base company's income is derived from sources within the U. S. If the company derives more than half of its income from U. S. sources, the personal holding company tax will apply whether or not any of the company's stockholders are citizens or residents of the U. S.

NETHERLANDS ANTILLES—A NEW TAX HAVEN

As AN EXAMPLE of the kind of tax benefits available in some foreign countries, take a look at what can be done in the Netherlands Antilles (Curacao)—which in case you've forgotten are islands off the coast of Venezuela—another country offering tax benefits and oil profits too.

As pointed out by James R. Rowen in a recent issue of *Taxes*, here are the benefits that can be obtained.

If a nonresident alien receives U. S. dividends, interest or royalties through a Netherlands Antilles corporation and such corporation distributes all its income in dividends, the total U. S. and Netherlands Antilles taxes will be as in the following table:

	U.S. Tax	*N.A. Tax*	*Total*
Dividends ...	15%	2.4%	17.4%
Dividends from 95% subsidiary .	5%	2.4%	7.4%
Interest	...	2.4%	2.4%
Patent royalties ..	...	24 %	24 %

In view of these reduced rates, a resident of a nontreaty country or a resident of a treaty country where the treaty does not limit the applicable rate or a resident of a treaty country who is not entitled to relief because he is engaged in business in the U. S.) may find it advantageous to receive his U. S. dividends, interest or royalties through a Curacao corporation, for his total U. S. and Netherlands Antilles taxes will be less than the U. S. tax that he would pay if he received such income directly. However, this advantage may in some cases be offset in whole or part if the taxpayer's country would allow him a credit for U. S. tax on income that he receives directly, but not allow him credit for the U. S. and Netherlands Antilles corporate taxes paid by his Curacao corporation.

Treaty-country taxpayers who benefit from a reduced treaty rate may not save any U. S. income tax by holding their U. S. stocks, bonds or royalties through a Curacao corporation. Indeed, if they organize a Curacao corporation and it distributes all its earnings in dividends, their total income taxes may be greater than if they received the income directly; their own country would probably allow a credit for the U. S. tax on income paid directly to its citizens, but is less likely to allow credit for the U. S. or Netherlands Antilles corporate tax on income received by the Curacao corporation. The advantage that such a treaty country taxpayer might derive from a Curacao corporation would be the elimination of U. S. estate taxes and, if the Curacao corporation accumulates income, a reduction in the taxes that he pays to his own country. Of course, if a Curacao corporation accumulates income, consideration must be given to the U. S. personal holding company tax. ☆

Only that part of the income of a foreign corporation derived from sources within the U. S. is subject to the personal holding company tax.

The personal holding company tax does not apply to "foreign personal holding companies" as defined in Section 552. The personal holding company tax imposed by Section 541 and the provision for taxing the undistributed income of a "foreign personal holding company" to its shareholders, outlined in Section 551, are two mutually exclusive provisions. Under 541 a "personal holding company tax" is levied directly against the corporation at a rate of from 75% to 85%. On the other hand, no special tax is levied against a "foreign personal holding company" under Section 551, which merely provides that the shareholders of such company will be deemed to have constructively received its accumulated earnings, even though those earnings are never paid out. United States citizens and residents who are shareholders in a foreign personal holding company must then include the company's current earnings in their gross income. It should be noted that the personal holding company provisions apply to both foreign and domestic corporations, while the foreign personal holding company provisions apply solely to foreign corporations. However, only those shareholders in a foreign personal holding company who are citizens or residents of the U. S. are affected by Section 551, while Section 541 will affect indirectly all shareholders of a foreign corporation, including those who are nonresident aliens, since the tax is levied directly against the corporation.

9. Foreign PHC provisions

The foreign personal holding company provisions, contained in Sections 551-57, effectively prevent the formation and operation of closely held foreign holding companies by U. S. citizens or residents. Section 551 provides that the current earnings of such foreign corporations shall be included in the gross income of their U. S. owners, even though earnings of the corporation are never actually paid out.

A foreign corporation will be classified as a foreign personal holding company, if roughly, two conditions are met:

1. At least 60% of the foreign corporation's gross income from the taxable year must consist of interest, dividends, royalties, gain on the sale of stock, or other receipts mentioned in Sections 543 and 553. If a foreign corporation has once been classified as a foreign personal holding company, however, only 50% of its income need consist of these kinds of receipts.

2. More than 50% of the value of the foreign corporation's outstanding stock must be owned, directly or indirectly, at some time during the taxable year by not more than five individuals who are citizens or residents of the U. S.

The above provisions also apply to a foreign corporation which is owned by a U. S. parent corporation, if more than 50% of the outstanding stock of the parent is owned, directly or indirectly, by not more than five individuals who are citizens or residents of the U. S. However, a widely held U. S. parent corporation, not over 50% of whose stock is owned by five individuals, may organize a foreign subsidiary without fear that the foreign personal holding company provisions will apply. Similarly, the provisions are not applicable to a foreign corporation which is closely held by U.S. citizens or residents, if the corporation derives over 40% of its gross income from the conduct of an active trade or business such as selling or manufacturing. Moreover, if aliens not resident in the U. S. control over 50% of the foreign corporation's stock, the foreign personal holding company provision will not apply. A foreign corporation, over 50% of whose stock is owned by nonresident aliens and less than 80% of whose gross income consists of dividends, royalties, interest, gain on the sale of stock, or other receipts mentioned in Sections 543 and 553, will not be affected by either the foreign personal holding company provisions or the personal holding company tax discussed above.

10. Collapsible corporations

The section prevents stockholders in a collapsible corporation from treating the distribution of accumulated earnings and appreciated property to them, or the sale or exchange of stock by them, as a long-term capital gain. A collapsible corporation is defined as "a corporation formed or availed of principally for the manufacture, construction, or production of property, for the purchase of property . . . or for the holding of stock in a corporation so formed or availed of, with a view to —

"(A) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, before the realization by the corporation manufacturing, constructing, producing, or purchasing the property of a substantial part of the taxable income to be derived from such property, and

"(B) the realization by such shareholders of gain attributable to such property."

Since a collapsible corporation is defined as 'a corporation" the term may also include a foreign corporation, even though Regulations issued under the 1939 Code did not so state. [*Rev. Rul.* 56-604 stated that a foreign corporation deriving all its income from sources outside the U. S. has no taxable income and cannot be considered collapsible.]

11. Unreasonable accumulation

The tax on unreasonable accumulation of earnings, imposed by Section 531, is applicable to foreign corporations which derive income from sources within the U. S. Practical difficulties in the exercise of jurisdiction by the U. S., however, may reduce the threat of the application of this tax to such foreign corporations. Moreover, the tax does not apply to income derived by foreign corporations from foreign sources.

Although a foreign corporation receiving income from sources within the U. S. may theoretically be liable for the accumulated-earnings tax, the Government may find it difficult, as a practical matter, to obtain jurisdiction over the corporation in a suit to collect the tax. If a foreign corporation has assets, such as real property or a bank account, in the U. S., its assets may be attached and an in rem judgment may be obtained by the Government for the amount of the tax. If the foreign corporation owns stock in a U. S. corporation, the Government may block the transfer of dividends, attach them, and obtain an in rem judgment against the proceeds. However, if a foreign corporation has no U. S. property which the Government may attach, there would appear to be little hope of enforcing the Treasury's claim for tax, since neither personal jurisdiction over the foreign corporation nor in rem jurisdiction over its property in the U. S. can be asserted. The fact that a foreign corporation has shareholders residing in the U. S. should not give the courts personal jurisdiction over that corporation.

Since under Section 531 the accumulated earnings tax is assessed against the corporation, the Commissioner will find

it extremely difficult to argue that resident shareholders should bear the tax on the theory that they have constructively received accumulated corporate income. On the other hand, if a foreign corporation against which an accumulated earnings tax has been assessed is liquidated and its accumulated earnings are returned to U. S. shareholders, the Government may be able to assess an accumulated earnings tax against the transferees. ☆

Canadian Commission proposes that tax on U. S. companies in Canada be changed

THE PRELIMINARY REPORT of the Royal Commission on Canada's Economic Prospects was presented to Parliament on January 10. The complete document contains only 116 pages of extremely well-written text that for anyone interested in the broad outlines of future Canadian development makes fascinating reading, reports the *Canadian Tax Journal*. While taxation does not bulk large in the report, there are references to it in several contexts and in most instances specific proposals are made. Following are a few extracts from the sections dealing with taxation in the oil and gas field in which American investors are numerous:

Important criticisms were offered of the tax system insofar as the oil and gas industry is concerned, namely: Canadians are at a disadvantage vis-a-vis the United States operators in the Canadian oil and gas field. In addition, the method of computing depletion allowances is not as favorable in Canada as in the United States.

Very generous tax treatment is given in the U. S. to individuals and to companies who invest in the oil and gas industry. For example, an individual with a large income, part of which is taxable at rates of, say 80% or even higher, may invest in oil wells and deduct any part of his expenditure which proves to be unproductive from the amount of his income which is subject to tax. This means that it costs such an individual only 20 cents or less out of every dollar which he spends unsuccessfully in looking for oil either within the confines of the United States or elsewhere; the balance is a special tax concession under the U. S. tax laws. Similarly the established U. S. oil companies, which spend by far the largest sums in exploration and development work throughout the world, receive very favorable tax treatment in comparison with other U. S. industries.

It is quite true that these tax policies place U. S. citizens and oil companies in a preferred position in searching for oil in Canada, compared with Canadian citizens and Canadian companies. But this does not mean that Canada should necessarily adopt the same policy. While we have a vital interest in the development of the oil and gas industry in this country, we have a vital interest in the development of many other industries as well. It would be an unwise practice for Canada to start favoring one industry over others through tax concessions merely because this is being done in the U. S. for reasons which, in that country, may be perfectly valid.

There seem to be two ways in which this problem might be dealt with. One would be to require all foreigners who wish to do business or to hold or develop resources in Canada to incorporate their businesses in this country under the Federal or under one of the provincial companies acts. However, there would be no assurance that this action would necessarily negate the tax advantages which U. S. citizens and companies enjoy at present under the tax laws of their own country. An alternative approach and one which we think would be a better one would be to devise some formula for giving companies in which Canadian citizens participate some special concessions under certain circumstances and conditions.

An objective of our economic policy should be that the larger or well-established Canadian subsidiaries of foreign concerns should sell some part of their equity stock to Canadians and include a number of independent Canadian representatives of such investors on their boards of directors. Some companies have adopted this policy and have said that it has worked out well and to their advantage. But it seems improbable that similar policies will be adopted by the majority of such concerns unless there is some material incentive for them to do so.

Some incentives might be provided by changes in the income tax law . . . With this in mind and if these suggestions for new and special tax concessions are accepted, it might not be unreasonable, in the opinion of the Commission, to make them conditional in their application to foreign-owned Canadian subsidiaries upon such companies, and more particularly the large or well-established ones, selling some part of their equity stock to Canadians and appointing independent Canadians to their boards of directors. There would be problems and difficulties to be overcome in any such plan, but we do not believe they would be insuperable. For example, some exception could be made in special cases for new ventures whose sponsors considered it would be unwise to invite public participation because of the uncertainties involved, and also possibly in the case of some smaller Canadian subsidiaries of foreign concerns which could not reasonably be expected to sell stock to the general public. Unincorporated branches of foreign concerns and Western Hemisphere Trade Corporations doing business in Canada might have the option of incorporating their businesses under Canadian laws and qualifying for the new and special tax concessions which have been suggested, or of continuing to enjoy whatever advantages they are at present entitled to under their existing forms of organization. This, incidentally, would tend to offset the advantages which certain foreign oil concerns, operating in Canada through the medium of Western Hemisphere Trade Corporations, enjoy at present vis-a-vis Canadian oil operators. ☆

Taxation of U. S. citizens abroad; a few simple steps help employee's tax picture

WHEN AN AMERICAN company sends a U. S. citizen abroad, it usually creates a headache for its payroll department which must be aware of some of the tax traps involving withholding from this employee, how to determine under what category he will be taxed and whether withholding is required.

Otherwise, the employee may fall into tax traps if the payments (particularly lump-sum ones) are made at the wrong time.

There are various classes of foreign citizens working abroad. Each is taxed differently on its earnings; each is subject to different withholding rules. All these rules are basically quite simple. "Resident in a foreign country," for instance, is not as complicated a concept as many think it is.

Resident in a foreign country

A "foreign country" does not include territorial possessions, which are governed by other rules. Residence means intent to stay for at least an indefinite time. Many cases apply this somewhat elusive rule; all are clear that residence must be established for an uninterrupted year. If this is established, the income for services rendered abroad and attributable to the period of foreign residence is nontaxable.

The employee's right to be taxed as physically present abroad does not depend on metaphysical subtleties of residence. The test is merely the number of days of physical presence abroad. If he is present in a foreign country or countries for 510 full days out of any 18 consecutive months, he can exclude either his earnings up to $20,000 for the taxable year or the proportionate part which the days in the 18-month period during the taxable year bears to the total days in the taxable year.

A few quirks in this rule must be watched carefully. The employee obtains no exclusion unless some part of the 18-month period falls in the taxable year. If he should return to the U. S. and then receive payment, such as a bonus, for the services he rendered abroad, he gets no exclusion unless some part of the 18-month period falls in that taxable year. Of course, if he is on the accrual basis or if he constructively received the income while abroad, this rule does not apply. And if the $20,000 is prorated by days, the exclusion might be cut down drastically.

A U. S. citizen who resides in Puerto Rico can exclude all income from Puerto Rican sources. Not only his salary, but his dividends, interest and any other income are excludable. No maximum applies. The citizen must meet the test of residence, not of mere physical presence, to obtain these attractive benefits.

He does, moreover, have to be careful about two limiting provisions. Under no circumstances can he get an exclusion for the year he begins residence, and to obtain the exclusion he must reside in Puerto Rico a full year. In the year that he leaves, he can get the exclusion only if he has resided there for at least two years.

The payroll department should be careful that the employee receives payment for his Puerto Rican employment-residence while he is there or during the year he leaves if the two-year rule protects that year. The employee's U. S. tax burden is eased if it defers payments for the year he took up residence. Of course, the doctrine of constructive receipt may make deferring unwise, and it should be carefully considered.

The employer need not withhold tax from an employee in a foreign country if either of two conditions exist. The first is that it reasonably believes that the income will be excluded on the basis of foreign residence or presence. The second is that the employee has signed a statement, prescribed by the Regulations and filed with employer's Form 941.

For residents of Puerto Rico no withholding need be made if the employer reasonably believes the employee will be either present or a resident for the entire taxable year. The employer may presume this to be true, except when it knows that he maintains his abode outside of Puerto Rico during the current or preceding taxable year. Of course, if the employee files the appropriate statement as prescribed by Regulations 120, Section 406.226(c), the employer does not have to withhold. But the Regulations mention no need to file, with Form 941, statements about employees in Puerto Rico. ☆

New foreign decisions this month

Trip to U. S. between foreign jobs broke foreign residence. Taxpayer claimed he was a resident of foreign countries during the year 1945 and that he was not taxable on foreign salary. In March 1945 he quit his job in the Netherlands West Indies, returned to the United States for two months and then went to Saudi Arabia on a new job. The court says that even if the taxpayer was a resident of the West Indies, his residence, at the very latest, terminated before his arrival in Saudi Arabia. Since he could not become a resident of Saudi Arabia until his arrival there, he could not be a resident of foreign countries for the entire year. [Under the 1954 Code, mere physical presence abroad for specified periods also exempts some foreign earnings. *Ed.*] *DeFir,* DC Cal., 1/28/57.

Corporate fraction limiting foreign tax credit compiled on full capital gain. The foreign tax credit cannot exceed the fraction of U. S. tax which foreign income is of entire taxable income. On a consolidated return this limiting fraction is computed on income including 100% of capital gain whether or not the tax is computed by the alternative method. [This is in accord with IRS ruling (*IR* 151) that full capital gains are included in computing corporate credits for dividends received, etc. However for individuals the IRS has held (*TIR* 1) that if the alternative tax is used the dividends received credit is based on income including only 50% of olong-term capital gain. *Ed.*] *Rev. Rul.* 57-116.

War loss deducted from foreign income in computing foreign tax credit. In computing its net income, taxpayer deducted as a war loss the seizure of its German subsidiary, but excluded this loss in computing its foreign tax credit. It thereby increased the numerator and decreased the denominator of the fraction of foreign tax allowed as a credit. It justified this action by stating that since the war loss provisions were added to the Code long after the tax credit, the war loss could not affect the credit. Further, it said that only expenses incurred to earn foreign income are allocable to foreign income in the computation. The court finds no merit in either argument. *Torrington Co.,* Ct. Cls., 3/6/57.

Procedures outlined for refund of withholding from wages paid nonresident alien. Tax which has been withheld from wages paid to a nonresident alien employee and which has not yet been paid to the District Director may be refunded by the employer to the employee. He should obtain satisfactory evidence that the employee has filed an appropriate income tax return and paid the tax, without claiming credit for tax withheld. Procedures to be followed by employer are outlined. *Rev. Proc.* 57-13.

NEW DEVELOPMENTS IN

State & local taxation

EDITED BY JOSEPH P. STAPCHINSKAS

Legislatures control only fifty cents of every tax dollar; earmarking is excessive

STATE LEGISLATURES often link the proceeds of a tax to the financing of a particular service. This is earmarking. Its extent is manifested by the widespread use of special funds which are depositories for collections from dedicated taxes. Expenditures from these funds are made for specified purposes and are contingent upon the receipts from the earmarked source.

Earmarking ties revenues to designated purposes in two ways. One is the allocation of receipts by constitution or statute, without legislative appropriation. Receipts accrue to the designated function automatically. Because dedicated amounts build up in a special fund and are not available for general state purposes, there is no legislative control. The second method is by legislative appropriation which allows revenue to accumulate for a specified purpose. As large amounts accumulate, legislative control over state finances diminishes.

The effects of this earmarking on state fiscal policies were pointed out in a Tax Foundation study entitled "Earmarked State Taxes." Pointing out that earmarking has reached such proportions that legislatures generally control only 50 cents of every dollar, the report said:

Earmarking of revenues may be desirable in isolated cases where those who receive the benefits must bear the costs, but it is subject generally to the following major criticisms:

1. Earmarking substitutes an indefinite yield of a single tax for a specific appropriation from general revenues based upon current needs.

2. Earmarking gives excess revenues to some functions and starves others.

3. Earmarking destroys the flexibility of the revenue structure, making it difficult for the legislature to adjust finances to meet changing conditions.

4. Earmarking infringes on the policy-making powers of legislative bodies by removing certain governmental activities from periodic review and control.

In fiscal 1954, 50% of total state tax collections were earmarked. The fact that state legislatures exert control over only 50 cents of each tax dollar imparts an unhealthy rigidity to state budgets. This rigidity is felt most keenly in periods of rising demands for new or expanded state services. The abolition of revenue earmarking would constitute a substantial step toward planning the expenditure of each tax dollar as carefully as possible.

In the 1930's, when the depression generated insistent demands for property tax relief, a solution was sought by increased reliance upon state taxes. The result was widespread adoption of new state taxes to finance far-reaching programs of state aid to localities and expanded services administered directly by the states.

Allied to the concentration of the taxing power in state governments was the adoption of earmarked taxes, which fell into two categories: (1) state-collected, locally shared taxes, frequently levied to relieve the local property tax and hence often allocated to local units for general purposes; and (2) state-imposed taxes retained either at the state level and set aside to finance a particular function, or allocated to localities with the stipulation that the revenue be spent for a state-specified function or purpose.

Motivating factors

The motivations which led to earmarking are not always identifiable. Initially, earmarking took the form of special assessments, which came into wide local-government use for financing certain types of permanent improvements to property. This practice was based on the benefit theory of taxation, that the taxpayer should pay in direct proportion to benefits received. This principle was later applied, not without some justification, to such functions as highways and fish and wildlife management. But the practice has spread beyond all logical boundaries.

In some cases, pressure groups have succeeded in obtaining more revenues for an activity through earmarking than if the activity's relative needs were considered annually in the general budget. Another motivating factor was identified recently by the governor of an eastern state, when he said:

". . . We all know how this system developed. It has been the common assumption that new taxes are always unpopular and that the best way to get uncomplaining acceptance of a new tax is to earmark it for an appealing purpose such as veterans' service or old-age assistance. This may be a defensible political theory, but it is not good fiscal management . . ."

Striving for good fiscal management, many states have set up machinery to improve fiscal control. Program or performance budgets, accrual-accounting systems, and integrated purchasing are typical management tools. But so long as considerable portions of state expenditures are dictated by legislative or constitutional formulas, these agents of control remain essentially ineffectual. In the final analysis, good fiscal management hinges upon legislative discretion and informed action in the matter of expenditure. Thus, the question of the dedication of tax revenues should receive prior consideration as state endeavor to gain control over expenditures.

Earmarking hampers state fiscal control

While revenue dedication may provide a relative degree of certainty upon which plans for the development of chosen functions can be based, it greatly impedes effective state fiscal control.

Usually, only expenditures from the state general fund are subject to effective budgetary control. They are limited by periodic legislative appropriations. Expenditures from special funds, in which earmarked revenues are most often placed, are not generally controlled by annual or biennial legislative appropriation. The use of special funds often reduces state budgets to hollow documents covering only a fraction of financial operations. Prudent fiscal management requires a comprehensive, flex-

ible budget based upon a common fund with no specific program favored by the returns of particular revenue. On this basis, legislatures can weigh relative needs of each state program according to their merit, without regard to the yield of a dedicated tax. However, when approximately five of every ten dollars collected in state taxes are earmarked, as was the case in fiscal 1954, legislative fiscal discretion is seriously impaired.

Revenue maldistribution is implicit in earmarking because there is no relationship between the yield from a dedicated source and the cost of the recipient activity. Some state services are oversubsidized, while others suffer from lack of support. California is a case in point. In only three years since fiscal 1946 have general fund revenues been sufficient to balance outgo. The current deficit is expected to increase under pressures of mandatory school costs and other fixed expenditures.

Ascribing the major portion of California's financial problems to an excessive number of uncontrolled expenditures, the state's Legislative Auditor recommended that certain earmarked funds be abolished and surpluses in the funds utilized for balancing the budget.

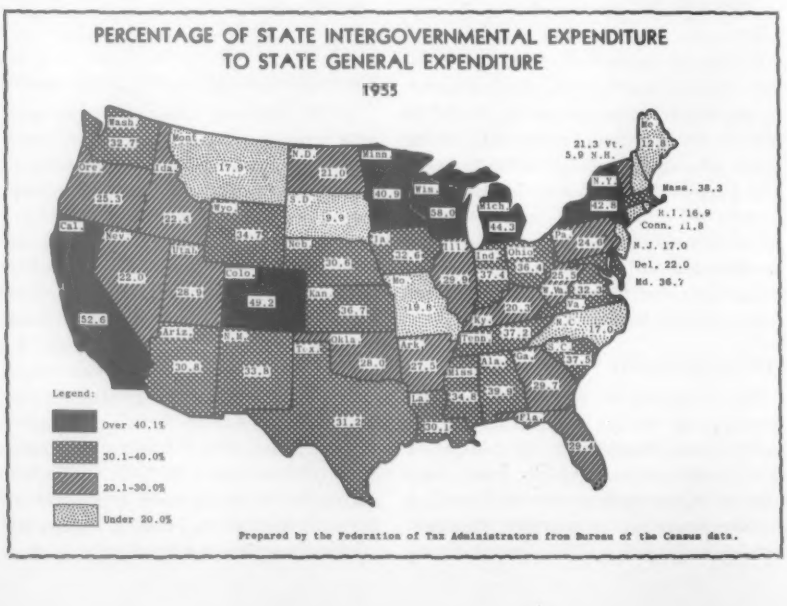
The abolition of special funds would enable the states to adjust fiscal operations to changing needs. Some element of flexibility is enjoyed in those states which permit use of special fund surpluses for purposes other than those in the earmarking provisions. Nonetheless, concentration of fiscal planning in the general fund assures that all activities receive equal consideration when reviewed by the chief executive and the legislature. Beyond that, the financing of state operations from a single unearmarked fund is a logical approach to the problem of fiscal control. With state financial needs focalized, the legislature can grasp more readily the various aspects of state financial operation and mold them into a balanced program.

Earmarked state taxes, however, do not represent the sole inroad into legislative fiscal controls over state revenues. Without exception, Federal funds received by state governments are earmarked. Also, state institutional and departmental receipts frequently revert to the credit of the collecting agency. ☆

State budgets don't reflect aid to local government

MANY OF THE FIGURES on state expenditures and revenues give us a false picture of state operations because the amounts in state budgets devoted to aid to local government vary so much. The chart below, prepared by the Federation of Tax Administrators, shows that these amounts range from 5.9% in New Hampshire to 56% in Wisconsin.

This variation is attributable to a number of factors. Contributing to a differing emphasis in aid payments in state financing are: (1) the extent to which local governments rely on property taxes to finance their own needs; (2) the distribution of functions between the states and their political subdivisions; (3) the extent to which the states have authorized local nonproperty taxes; and (4) the level of services established.



The chart shows the percentage which intergovernmental expenditure is to state general expenditure in each of the 48 states. Intergovernmental expenditure consists of amounts paid to other governments as fiscal aid or as reimbursement for general government services performed. Principally, it represents state aid to local governments both in the form of shared taxes and grants-in-aid, whether earmarked for specific purposes or available for general governmental use.

The Census Bureau report shows that each of the 48 states makes payments to local governments for education. Every state but West Virginia makes such payments for highways. Some 29 states report intergovernmental expenditure for public welfare. All but six states reported aid payments of some amount for unspecified purposes. Although aid programs have been adopted by most of the states, there are wide differences in the volume and the nature of state payments for these programs. ☆

New decisions

Loss on subsidiary's sale to parent disallowed. A Missouri corporation which published a newspaper in Kansas City purchased a paper mill in Wisconsin which it operated as a subsidiary division. For a three-year period thereafter, it purchased newsprint from the paper mill at a price based on its payments to other paper mills. This failed to meet the cost of manufacturing the newsprint. The mill had been designed for purposes other than the efficient manufacture of newsprint and had been bought because of a severe newsprint shortage.

The Wisconsin income of the paper mill was reported on a separate accounting basis which showed an operational loss. The state assessed tax on a profit it computed as 8% of sales. The state board of tax appeals holds that there is no basis for an assessment on an assumed percentage of profit, but that for the purposes of taxation, the price of the purchased newsprint could be no less than the cost of its production. The board holds that the controlling issue was not what constitutes a fair price to the division but whether the device used by the corporation resulted in an improper reduction of profits of the paper mill division and avoidance of income taxes to which Wisconsin is entitled. *Kansas City Star*, Wisc. BTA, 1/4/57.

EXCESS PROFITS TAXATION: RECENT DECISIONS

Coal-mining company denied Section 722 benefits. A coal-mining company claimed Section 722 relief for 1944, and the benefits of unused excess profits credit carryovers from 1942 and 1943. It contended that unusual and peculiar events affected its production during the base period. Relief is denied as the company failed to show that a logical constructive-average base-period net income could be established which would exceed the benefits already allowed under Section 712(e). *Clayton Coal Co.*, 27 TC No. 99.

Corporation leasing lands for mineral extraction fails to get Section 722 relief. Ever since its organization in 1907, taxpayer-corporation attempted to lease its lands for the extraction of minerals. In 1917 it leased its property for oil development; in 1925 it tried to interest others in the development of its salt deposits; in 1932 it leased part of its property for limestone extraction; in 1937 and again in 1941 it leased its property for oil development. Taxpayer at no time attempted to develop the mineral resources of its property itself. The court holds taxpayer did not change the character of its business during or immediately prior to the base period nor was it committed, prior to January 1, 1940 to a course of action consummated subsequent thereto which resulted in any change in its capacity for production or operation so as to qualify for excess profits tax relief under Section 722. *Le Danois Land & Stone Co.*, 27 TC No. 98.

Equity capital includes liabilities forgiven by creditors [*Acquiescence*]. The court determined that taxpayer realized income from the forgiveness of debts totaling $70,000 to the extent the forgiveness rendered taxpayer solvent ($28,000). The entire amount of forgiven debt is includable in equity invested capital. *Capitol Coal Co.*, 26 TC No. 148, *acq.* IRB 1957-6.

Purchasing corporation permitted partial use of the earnings-experience base of selling corporations. In 1948 and early 1950, taxpayer acquired the assets of four banks for some cash and the assumption of their deposit liabilities. For purposes of computing its excess profits credit based on income, taxpayer is permitted to take into account the income experience of the four banks — but only that portion properly attributable to the portion of the assets acquired in consideration of its assumption of the deposit liabilities. *National Bank of Commerce of Seattle*, 27 TC No. 92.

EPT invsted capital in 1925 consolidation included positive and negative goodwill. In 1925, many companies merged to form taxpayer. Its invested capital for excess profits tax is computed by determining the value of property paid in for its stock; that property is the stock of the merged companies. In the absence of market values for the stock, the Commissioner valued the assets of each. He computed goodwill by capitalizing at 20% the excess earnings of companies earning more than 10% on their capital. This amounted to about $3.2 million. However for companies which earned less than 10%, he computed a "negative" goodwill, i.e., the amount by which the assets exceeded ten times the earnings. In total, this discount amounted to $2.2 million. He therefore allowed only $1 million goodwill. The court agrees. In effect, the Commissioner compared total earnings of all companies with total assets of all companies and computed the merged goodwill. This method is fair. *General Outdoor Advertising Co.*, Ct. Cls., 3/6/57.

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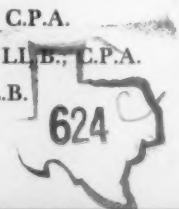
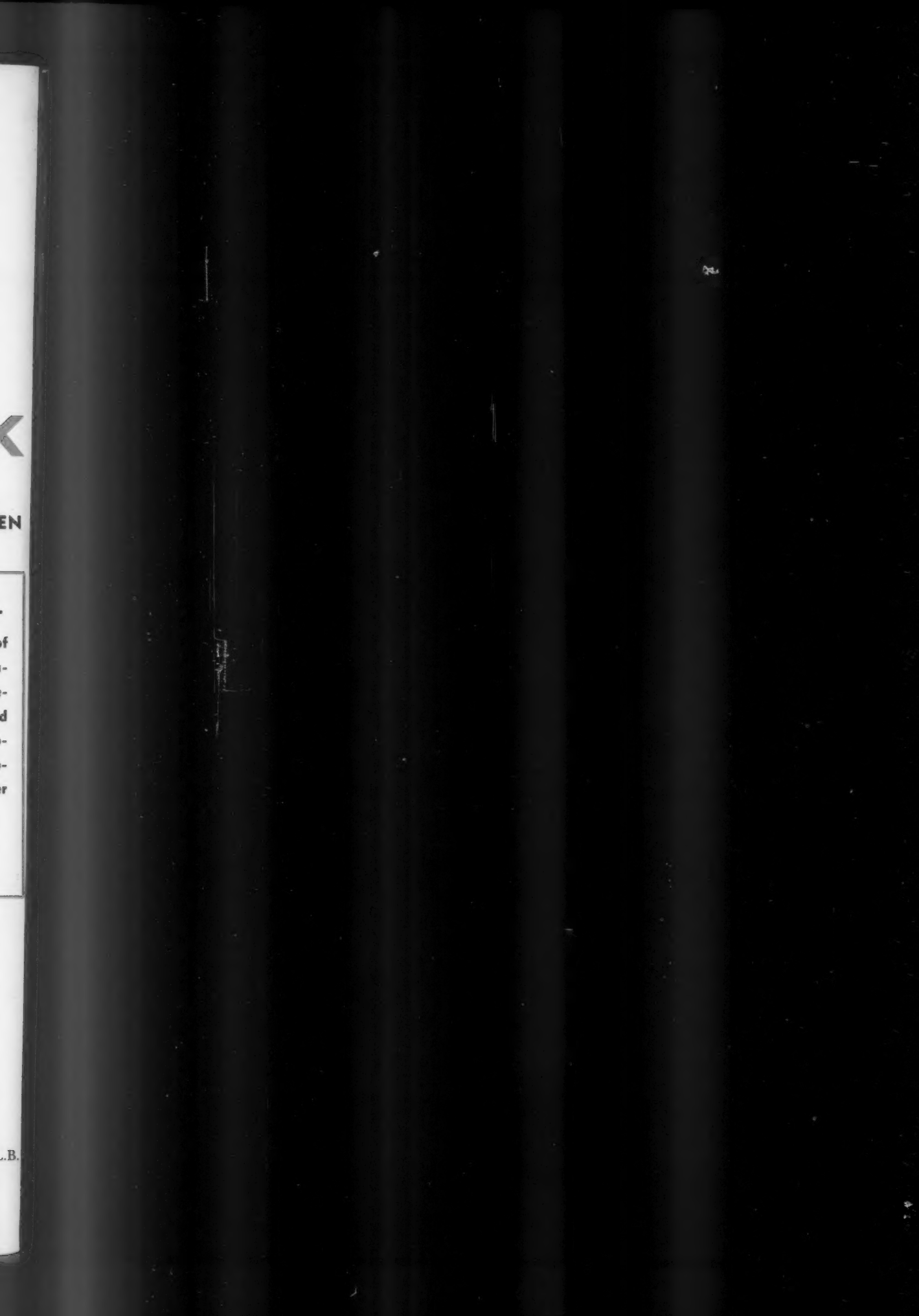
(Lecturer in Federal Taxation, University of Virginia, Editorial Advisory Board of the Journal of Taxation.)

CONTRIBUTORS

Richard H. Barrick, LL.B.
Carolyn Clarke, LL.B.; C.P.A.
A. Gordon Colley, Jr., LL.B.; C.P.A.
Wallace M. Davies, LL.B.
Kenneth E. Fox, LL.B.
Daniel S. Knight
William J. Linkous, Jr., LL.B.
Charles M. Lobban, LL.B.